COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

STANDING COMMITTEE ON ECONOMICS

Reference: Private equity investment and its effects on capital markets and the Australian economy

WEDNESDAY, 25 JULY 2007

SYDNEY

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SENATE STANDING COMMITTEE ON

ECONOMICS

Wednesday, 25 July 2007

Members: Senator Ronaldson *(Chair)*, Senator Stephens *(Deputy Chair)*, Senators Bernardi, Chapman, Hurley, Joyce, Murray and Webber

Participating members: Senators Adams, Allison, Barnett, Bartlett, Boswell, Boyce, Bob Brown, George Campbell, Carr, Conroy, Eggleston, Chris Evans, Faulkner, Ferguson, Fielding, Fifield, Forshaw, Hogg, Kemp, Kirk, Lightfoot, Ludwig, Marshall, Ian Macdonald, Sandy Macdonald, McGauran, Milne, Nettle, O'Brien, Parry, Payne, Robert Ray, Sherry, Siewert, Watson and Wong

Senators in attendance: Senators Bernardi, Fielding, Joyce, Ronaldson, Stephens and Webber

Terms of reference for the inquiry:

To inquire into and report on:

a. an assessment of domestic and international trends concerning private equity and its effects on capital markets;

b. 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;

c. an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects;

d. 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

e. an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

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Committee met at 9.01 am

CHAIR (Senator Ronaldson)—I declare open this meeting of the Senate Standing on Economics. This hearing has been convened to receive evidence in relation to the committee's inquiry into private equity investment and its effect on capital markets. The Senate referred this reference to the committee on 29 March 2007 and the committee received 27 submissions. The committee is due to report on 16 August 2007. These are public proceedings, although the committee may agree to a request to have evidence heard in camera, or it may determine that certain evidence should be heard in camera.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee. Such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee.

If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, the witness may request that the answer be given in camera. Such a request may, of course, also be made at any other time.

Any claim that it would be contrary to the public interest to answer a question must be made by a minister and should be accompanied by a statement setting out the basis for the claim. The Senate has resolved that an officer of a department of the Commonwealth or of a state shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions asked of the officer to superior officers or to a minister. This resolution prohibits only questions asking for opinions on matters of policy and is not for questions asking for explanations of policies or factual questions about when and how policies were adopted.

I bring to the attention of honourable colleagues mention in the *Economist* on 21 June this year, in reference to similar hearings before the British parliament's Treasury Committee, where it was stated that those participating were cantankerous and sometimes incoherent. I request that we do not follow the same lead as our colleagues in Britain. That is probably the lightest thing that will happen during the course of these proceedings.

[9.04 am]

BATTELLINO, Mr Ric, Deputy Governor, Reserve Bank of Australia

BROADBENT, Mr John Stanley, Head of Domestic Markets, Reserve Bank of Australia

CHAIR—Welcome. Mr Battellino, would you like to make an opening statement?

Mr Battellino—Thank you very much, Senator Ronaldson. I thank the committee for giving the Reserve Bank the opportunity to appear here today to talk about private equity. As you know, the Reserve Bank published an article on private equity in the March 2007 edition of—

CHAIR—Could I interrupt briefly. You distributed a document to senators this morning. Would you like to seek leave to table that document?

Mr Battellino—Certainly. As I say, we published that article, and this document, which I distributed this morning, in some ways summarises and updates that article. So I submit that as part of the evidence here today. I will be talking to some of the charts, if that is acceptable.

CHAIR—You have leave to table that document. Please proceed.

Mr Battellino—As I was saying, we have prepared this set of charts which summarises that earlier work. That work took into account information that the Reserve Bank had collected on private equity. It also took into account discussions that had taken place at the Council of Financial Regulators.

CHAIR—Would you go through the participants on that council, please?

Mr Battellino—Certainly. The council is chaired by the Governor of the Reserve Bank. Also represented on the council are the Treasury, APRA and ASIC—the four main financial regulators.

CHAIR—Thank you.

Mr Battellino—There are four key points I would like to make in relation to private equity in my comments here today. The first is that the surge in private equity which we saw last year was really a global phenomenon; it was not something specific to Australia. In fact, Australia was quite a small part of what was happening globally. The increase that we saw was in what is known as ‘leveraged buyouts’, one of the forms of private equity. That increase was driven by very unusual circumstances in global capital markets last year and in particular by the very low cost of debt. At the same time, returns on equity were very high. That combination of circumstances made it very attractive to use debt to take over equity.

When you look at the charts on private equity, you see that there seems to have been a very large increase in activity last year. I think it is important to keep in mind that the private equity finance we saw last year remains a very small part of the overall financing that takes place in the

economy. As such, our view is that these developments pose absolutely no risk to the stability of the financial sector or the economy more generally. The final point I would make is that there is anecdotal evidence that private equity activity is already starting to wane. Every day in the papers now you see that companies in the United States have had to shelve their plans to raise debt because the cost of debt is rising and, perhaps more importantly, investors are becoming more cautious, so it has become more difficult for companies to issue debt.

With those brief comments out of the way, can I start going through the charts that were circulated? The first few charts deal with the global picture. I should start by defining exactly what I mean by ‘private equity’ because this is quite a loose term—it does not have a precise definition and people use it in different contexts. There are two main types of private equity, in our view. One is what is known as ‘venture capital’. This is a very specialised form of financing which usually involves an investor or a small group of investors subscribing capital to start up a firm or firms. This form of financing has had a long history and is growing steadily. The other form of financing or private equity is what is known as ‘leveraged buyouts’. This typically involves private investors taking over a company that is listed on the Stock Exchange and making it so-called ‘private’—that is, delisting the company. This form of financing usually makes use of a lot of debt or leverage; hence the name ‘leveraged buyout’. It is really this second form of financing, I think, that has been the focus of much of the public debate and discussion over recent months. So, in our comments today, we are really focusing on leveraged buyouts.

If you look at graph 1, you can see that there was a very sharp increase in total global private equity activity last year—over $800 billion. The orange sections of the bars there show the proportion that was due to venture capital. You can see that that has not really done much at all; in fact, it was much bigger through the tech bubble in the late 1990s, when there was a lot of start-up capital devoted. But the big increase, as you can see, has been in leveraged buyouts. Now, $800 billion sounds like a very large number—

CHAIR—That is US, isn’t it?

Mr Battellino—that is $US800 billion—but it accounts, for example, for less than two per cent of the total size of global debt and equity markets, so it is important to keep it in that context.

Moving now to the second chart, this chart breaks up those figures we saw in the first chart into various regions. You can see that the main increase has taken place in North America. There was $400 billion of leveraged buyouts in North America last year, accounting for, in other words, half the global activity. You can also see that Europe had a big increase, and ‘other’, which is mainly Asia, also had a smaller increase. I have put on there for comparison the figures for Australia at the bottom in yellow. You can see that, on the global scale, the level of activity in Australia is really quite small. I will come back to Australia in more detail later.

Moving now to chart 3, I would like to explain the typical structure of a leveraged buyout. This form of financing usually has two types of funding: equity and debt. Equity funding is usually the smaller part of the two and typically amounts to around a third of the overall funds contributed. The debt component, which makes up the other 70 to 75 per cent, is usually then structured into various types of debt, depending on its level of creditworthiness. The more senior debt is typically about half the overall funding, and then lower ranking debt such as subordinated

debt and mezzanine debt makes up the rest. So, if you see that financing, you can see that the gearing ratio, which is the ratio of debt to equity, is typically over 200 per cent. In that example there, we have 70 per cent debt and 30 per cent equity. The debt is more than two times the equity.

That is a higher level of gearing than is typical for a listed company. On the right-hand panel there, you see that listed companies typically have more equity than debt. The capital structure of a listed company typically averages out at about 60 to 70 per cent equity and 40 per cent debt.

CHAIR—Would you be returning in your evidence to talk about the Australian experience with the Australian banks and—

Mr Battellino—Yes, I will come back to Australia in the second part of the presentation.

CHAIR—Thank you.

Mr Battellino—Moving on to graph 4, again this is the global graph. This time the bars are broken up into their equity and debt components. You can see that the equity component, which is the purple line there, typically makes up about a third of each bar, so that is illustrating the point made from the previous graph.

CHAIR—Mr Battellino, there are a number of members of the press here today. If you are referring to some of these figures, could you perhaps use the figures as well as referring to the bars, just for the benefit of those who might be listening.

Mr Battellino—Sure.

CHAIR—Thank you.

Mr Battellino—Just coming back to graph 4, let us take the 2006 bar—and, as we mentioned before, the total bar is $US800 billion. If we divide that into its equity and debt components, we have about $US280 billion of equity and about $US530 billion of debt.

I would like to move on and talk about who is providing the funding for these LBOs. In terms of the equity funding, there are no hard numbers available, but I think it is broadly accepted that the bulk of the equity money that comes into these LBOs is coming from institutional investors—pension funds, mutual funds, endowment funds and things like that. I think the consensus is that, roughly, on a global scale, about 80 per cent of the equity money coming into these funds is basically coming from these institutional investors, which are in turn reflecting the average savers in the economy, because these institutional investors are basically pooling the money from the average person.

On the debt portion, we have a bit more information about who is holding the debt for these LBOs. I think the interesting point here was, as you can see on graph 5, the big change in the composition of who was holding the debt over the past 10 or 12 years. If you look at the bar for 1994, you can see that 70 per cent of the debt was being held by the global banks. At that point, hedge funds took up about 20 per cent and the rest was held by a range of other investors. The bar on the right shows the corresponding figures for 2006. The thing that is striking is that the

amount of debt that is held by the banks has fallen down to about 20 per cent and the bulk of the debt is now held by the hedge funds. What has been happening here is that, even though the banks are typically the ones that are initiating the financing and are providing the initial loans, they are subsequently securitising those loans and selling them off to a range of investors. The hedge funds are particularly important in that area. The hedge funds and a few other investors are really the main ongoing source of funding for these sorts of vehicles. That more or less summarises what I wanted to say about the global developments.

I would now like to move on to what we know about Australian private equity. Chart 6 sets out the corresponding figures for Australia. Again, the bars are divided into two components: the blue part is the leverage buyout and the orange part is venture capital. Again, you can see that the venture capital is significant, but it is not growing exponentially. It is basically growing steadily. You will notice from that graph that there was a very large increase in 2006. The number of deals completed amounted to about $A14 billion last year, and virtually all of that was from LBO activity.

CHAIR—Can I just halt you briefly for a point of clarification. In your financial stability report of March there was a figure that was closer to $25½ billion. I presume that your revised figure accounts for the Qantas sale not proceeding and has been reduced accordingly—is that right?

Mr Battellino—That is correct. These figures as published included completed and announced deals and, as you know, the Qantas deal subsequently did not go ahead, so we took that out of the figures. You can see from the graph that the same thing as happened in 2006 is happening for 2007. If you look at the far right bar, you will see that so far in 2007 we have had about $2 billion in deals completed and there is about $12 billion in deals that have been announced. That $12 billion is mainly accounted for by the bid for Orica by Bain Capital, which is a US private equity firm.

If we move on to graph 7, it is basically the same graph as graph 6, although in this case we have overlaid that orange line, which scales those figures by the size of Australia’s capital markets. You can read the scale off the right-hand side. So you can see that even though the figure last year was large in absolute terms—$14 billion—if you scale it by the size of the Australian equity market, it was only about one per cent of Australia’s equity market. It is interesting to note that in 1989 the figure was much larger. It was about four per cent of the equity market. Those figures are very similar to what we saw in the global picture. These figures are still quite small relative to the overall size of capital markets.

Graph 8 looks at who is providing the funding for the Australian LBO activity. This is shown as a pie chart and it takes into account the average funding for all of the deals completed over the past five years. You can see there that equity has made up about one-third of the overall funding. That is a combination of the yellow section of the graph, which is the foreign equity, and the orange section, which is the amount of equity provided by Australian investors. The thing to notice there is that, again, the foreign equity greatly exceeds the amount of money provided by domestic investors, so this is really money coming from offshore.

If you look at the debt component of the funding, we can see again that the biggest providers of funding here have been the foreign banks. We have shown Australian banks in the blue

section, the amount provided by the five largest banks in Australia. That has been a much smaller part than what the foreign banks have provided. I should mention here that this is the initial funding, because we can never trace through who ended up holding all this debt eventually. It could be that some of this debt has subsequently been onsold to other investors such as hedge funds and other institutional investors. If you look across the total amount of debt outstanding to LBO type activity, our estimate is that there is probably about $20 billion of this debt outstanding to Australian private equity companies. Our calculations suggest that, of that, less than $5 billion is on the books of Australian banks. This is less than one per cent of their overall lending and we therefore conclude that this is not posing particular risks to the Australian banking sector.

Graph 9 provides a little bit more information on the source of this equity funding. It basically takes the orange section from graph 6, which is the total amount of Australian equity, and tries to show how much of it is coming from Australian superannuation funds. You can see that they are the biggest provider of Australian equity into these LBO activities. Typically, about half the domestically sourced equity is coming from superannuation funds. A lot of superannuation funds increased their exposures to private equity and other alternative investments, such as hedge funds, after the share market correction that happened in 2000 because they were looking to achieve more stable returns and, in some ways too, they were looking to copy the very successful record that some of the university endowment funds had in the US where they had a very long history of investing in unlisted vehicles, such as private equity and hedge funds. So this has been a growing trend over the last few years in superannuation money.

Those graphs basically summarise the factual material we have on private equity activity. I now have some charts which try to go through some of the questions that arise out of that material, in particular questions such as: what has driven this increase in LBO activity; what impact has it had on corporate gearing; and will private equity end up displacing the stock market?

Let me deal with the first of those questions—in other words, what has driven the rise in private equity? Graph 10 tries to illustrate what we think is the main driver here. It is important to recognise that LBO activity has been a global event, so therefore the reasons why it happened have to be global. It is easy to see, when you look around global capital markets, why it happened. Basically it came down to the fact that the cost of debt has been very low and that debt has been readily available. This has allowed companies to access debt and use that to take over equity. So the return on equity has been very high, and therefore there has been a big financial incentive to replace equity with debt.

The figures in chart 10 relate to Australia, but, if you did this graph for a range of other countries, it would look very similar. The blue line you can see is the earnings yield on equities, and the pinkish line is the real yield on debt. You can see the big gap that has opened up there—in other words, the cost of debt is much less than the cost of equity capital. As I say, that provided a very strong incentive to substitute debt for equity.

Senator JOYCE—May I ask something there, Chair?

CHAIR—I think we will leave it, if you wouldn’t mind, until we get to questions.

Senator JOYCE—Fair enough.

Mr Battellino—On that point, I think it is also interesting to see from the graph that that gap is starting to close. It is starting to close for two reasons. First of all, the cost of debt is going up, and a big factor there has been the problems experienced in the US mortgage market in recent months. This has meant that spreads on corporate debt and lower rated debt have risen so it has become more costly for investors to raise debt in the US. Keep in mind that the US is where a lot of the debt is being raised. I am sure you would have seen reports in the papers in the last month or so that quite a number of deals have fallen over or had to be delayed because investors are just refusing to buy the debt now.

At the same time, the earnings yield is coming down. I think that is because the existing owners of listed companies are starting to ask a higher price in order to be prepared to sell. They have worked out that there is a big demand for equity and, if you are going to sell, you want a high price for it. That is pushing it down. So the market is working and it is starting to equilibrate. So the returns on equity and debt are coming back more into line. Our feeling from that is that basically we have seen the surge in LBO activity and it is unlikely to continue at the pace we saw last year. I think the market has equilibrated.

The second issue is the impact that LBO activity is having on corporate gearing. Chart 11 deals with this question. It is divided into two panels. The top panel looks at the gearing of listed companies. Each bar there shows the proportion of companies at various levels of gearing, which are shown across the bottom section. You can see in the far left-hand bar of the top panel a figure of close to 50 per cent. That is showing that about half the listed companies in Australia have virtually no gearing. Most of the rest have small amounts of gearing. As I said before, if you average it over the whole listed company sector, the average gearing ratio is about 70 per cent. So these companies have less debt than they have equity.

The bottom panel of the graph shows the gearing ratio for companies that have been taken over by leveraged buyouts. These bars are much higher up the scale. The gearing here ranges typically from around 100 per cent through to about 400 per cent, and it averages out at about 250 per cent. We can see a very big difference in gearing between listed companies and these companies that have been taken out by leveraged buyouts.

The question is: how significant is this overall? Graph 12 deals with that question. The yellow line shows the average gearing of all the companies listed on the Stock Exchange. You can see that in recent years the gearing has been coming down. In fact it was under 60 per cent a couple of years ago. The orange dot we have at the very end shows what would happen to that gearing ratio if you added back in the companies that are shown on the bottom panel of the previous graph—so all the LBO type companies. You can see that, even though the gearing ratio of those companies is much higher, because they are such a small part of the market their effect on the average is fairly insignificant.

I think the bigger impact of LBO activity on corporate gearing is probably coming through from the impact it is having on the behaviour of listed companies. I suspect that quite a number of company boards are themselves looking to increase their gearing in order to protect themselves against takeover. In other words, in order to make sure that somebody else does not take over their equity by using debt, they are using some debt themselves to gear up their

positions. It could be that some of that rise in the yellow line we saw in the last year or so may be due to the changed behaviour of company boards in response to private equity activity.

The final point I want to deal with is whether private equity will displace the stock market or threaten the stock market in any way. I think our view is pretty clearly no. There are a few issues to consider here. The first is that, even after the big surge in private equity we had last year, the overall level of activity in that market remains very small relative to the overall equity market. The second point, as I said, was that the unusually large gap between equity and debt returns that we saw last year is starting to go away, so this level of activity that we saw last year was probably starting to fade. As I say, recent anecdotal evidence suggests that that is happening.

The third point, which is a very important point, is that there are still a lot of advantages in institutional investors holding their core equity investments via listed companies. The key advantage, of course, is liquidity. This is because if an institution puts its money into private equity it typically has to lock that money away for quite a number of years—five to 10 years, in some cases. While institutional investors might be willing to do that for a small part of their overall portfolios, it would be quite risky to lock away big parts of the portfolio for that sort of period. I think this will act as a natural limit on the extent to which institutional investors are prepared to put money into private equity. As we saw from the earlier graphs, it is these institutional investors that are often the source of the money that is funding this private equity. So I think there is a natural limit on what can happen here.

There is a final consideration which is illustrated in this last graph. When these private equity firms want to exit their investment they usually do so in a way that involves relisting the company on the Stock Exchange. For example, over the last five years about 40 per cent of the exits out of private equity took place through an initial public offering—that is, listing shares back on the Stock Exchange. Another 40 per cent or so have taken place through trade sales, and a lot of these trade sales involve selling the private equity firm to another company that is already listed on the Stock Exchange—so, again, a de facto form of listing. That basically brings together what we know about private equity and our general views.

Let me end by saying that I think the global surge we saw in LBO activity last year was the result of very unusual circumstances in capital markets at that time. I think those conditions are already starting to change, so it is very unlikely that LBO activity will continue at the pace we saw last year.

Senator STEPHENS—Thank you very much for that presentation. It was very succinct and very helpful for us. I just want to go back to one of the points you made in relation to the way in which this is having an impact on the behaviour of listed companies. You suggested that one of the activities is that they are gearing up to prevent being taken over. Can you tell us what impact that is having on perhaps shareholder returns or capital returns? What is the effect of that action in the short term?

Mr Battellino—Usually the return on equity is higher than the return on debt. So, if you are running the company, to the extent that you can use debt to fund some of your activities, there is more money left over for the return on equity. On the other hand, the more debt you are using, the more variable your operations become, because the return on debt is fixed, so you are committed to paying that every year. So companies are always trying to trade off this set of

circumstances: 'We want to try and increase the return on equity as much as possible but, at the same time, we have to maintain an eye on how much variability can happen in our returns, and can we afford to pay the interest?' So, in the short run, if companies are gearing up to some extent, I think it will increase the return on equity.

As you can see from the graph we showed there, in recent years companies have run down their gearing quite a lot from where it was in the eighties. Obviously, in the eighties, many companies felt they were overgeared. The gearing ratio got up to over 100 cent, and they brought it back a long way. I think in recent times some companies are starting to reassess whether they have come down too far. This was clearly the view that a lot of private equity investors had—that companies had reduced their gearing too much, and there was money to be made by taking on a bit more risk. That is the trade-off that companies have to make: how much variability can they tolerate in their returns?

Senator STEPHENS—I have one other quick question. At the top of page 65 of your financial stability report—the excerpt from the report that relates to private equity—you make some comments and observations. You say:

> Another commonly cited driver of the increase in private equity investments is the potential for private ownership to allow better management of a particular company—

including being 'away from the public gaze' and able to actually reassess. Can you elaborate a little on that for us as well? That is a concern that has come through in many of the submissions—that being out of the public eye means that there is less scrutiny and therefore perhaps, in some submissions, even concerns about not dubious practices but high-risk practices in those areas.

CHAIR—For the benefit of colleagues, that is page 7 of the excerpt.

Mr Battellino—We at the Reserve Bank are not experts in corporate governance, but my impression is that what is happening here is that a lot of the attention of managers of corporations, listed companies, these days has to go to meeting the short-term needs of shareholders. There are a lot of disclosure requirements. Shareholders themselves, particularly through the superannuation funds et cetera, are actually quite activist. They want their returns, they want them steady and they want them all the time. A lot of attention, a lot of management time, goes in keeping these shareholders happy.

If you talk to the average business person, they feel they would had more time left over to run their company if they did not have to deal with shareholders. This is one of the reasons they like private equity. Imagine if you owned a company yourself. You know what you are doing. You do not have to waste time trying to convince somebody else that you are doing the right thing; you just go ahead and do it. Small or like-minded investors get together and say, 'This is what we want and we run the company the way we want to.' That is the sort of sentiment we are picking up from the corporate sector. You mentioned the word 'dubious'. I do not think there is anything dubious going on in these companies. It is simply the fact that, if you own the company yourself, you do not have to spend a lot of time preparing reports and keeping shareholders happy.

Senator JOYCE—Those pesky shareholders: they are always a problem! I want to concentrate my questions on three issues: transparency, vulnerability and interest rates. I should start with the first. If you believe that private equity firms are going to the market in search of funds—and take into account that they are getting it from the US mortgage market or wherever—and that to combat this the companies themselves are going back into the market and buying more funds, should this not mean that there is a greater demand for debt and so intrinsically we are forcing up interest rates by the advent of private equity funds?

Mr Battellino—When we talk about interest rates, I think we need to distinguish two different things. There is the risk-free rate. Let us go back to the very short-term interest rates, which is what the central banks set. They are determined by economic activity and inflation. As we move further out the security spectrum, more factors come into account in what determines the level of interest rates. The main benchmark is typically the interest rates at which governments can borrow, the so-called 'risk-free rate'. In recent years that has been very low, mainly because governments have not been doing a lot of borrowing and the demand for debt in global markets has been very strong, driven mainly by excess savings coming out of Asia. At the same time, we have seen spreads on corporate debt fall. So corporate bonds are usually traded at a yield higher, obviously, than that at which the government can borrow. Those spreads over time have come down because economic conditions have been very good, default rates have been very low, investors have been searching for yield, so they have been prepared to take on debt at lower and lower yields because they are trying to maintain their rate of return.

In recent times, I think it is the case that as the demand to issue debt increases, it puts upward pressure on those spreads. So we do not see any change in the risk-free rate at which governments can borrow, but the spread at which corporations can borrow starts to rise and we have seen that. In the last month or two, we have seen spreads on corporate bonds rise by up to 100 basis points, so one percentage point.

Senator JOYCE—It is really not that complicated. People just use the rule of 72 and take off their interest rate, and if they can basically hold the debt, in due course they will own the company by the yield of the company. I am a simple old accountant from St George. I can work that out, so I imagine they can work it out too. Inevitably, if it is going to die naturally, it is going to die naturally by reason of interest rates going up to knock that possibility out.

Mr Battellino—Yes. There is limited at-risk appetite. Investors are prepared to devote a certain amount of their portfolios to higher risk investments but not all. We have seen in the last month or so that investors are saying: 'We bought a lot of these securities last year. We've got enough.' So now, when issuers go to the market, they are finding some resistance.

CHAIR—Just so I am clear on this, what you are saying is that in relation to official interest rates, there is not going to be any negative impact from private equity transactions but there will be some risk pricing in relation to the amount that the corporate sector will be required to pay to borrow in the future. Is that what you are telling this committee?

Mr Battellino—That is right.

Senator JOYCE—Onto the next issue. I credit you for your report in March. It was a very good report and very concise. My query is: are we going to get that continual feedback on what

is happening, or was that just a one-off? It was a very important document. What will your reporting structure be into the future? How will you deliver information back to our nation about how this process is going forward?

Mr Battellino—The bank's approach is to monitor all developments in capital markets, as well as the economy, globally and domestically. We have a big team of economists and analysts there and we are keeping track of all the things that are happening. When we see something unusual happening—as we saw late last year in relation to private equity—we start looking a bit more deeply. The article that we published early this year was the outcome of the analysis that we did. This was something unusual happening, so we thought that we would write something about it. We did a similar thing on CDOs, collateralised debt obligations. That was another unusual development. The bank's policy is to write and talk to the community about unusual things and important things that are happening. While ever private equity remains a big issue, we will continue to monitor and write about it. There are various vehicles for doing that. We produce a *Financial Stability Review* every six months. As I said, while ever this remains a topical issue, we will be commenting about it in the review.

Senator JOYCE—So does that means that we are going to get regular reports?

Mr Battellino—While ever it remains a topical issue. Are we going to have regular reviews on private equity for the next 10 years? Maybe not, because if this does what it did in the early 1990s and dies away to nothing, we can summarise what is happening in the space of a paragraph rather than a 20-page document.

Senator JOYCE—So, while it remains at the level that it is, we are going to get regular reviews?

Mr Battellino—Yes. And while ever anything topical is happening in that area. It could be that activity falls away but credit concerns arise. There will be issues around.

Senator JOYCE—How are we going to get that information without some kind of code conduct around how these people deliver the information? Obviously, as you said, in essence, once a person goes to a private equity firm they have inherently pulled down the shutters on transparency. Therefore, how are you going to get access to that information about what they are doing?

CHAIR—I do not think that those were Mr Battellino's comments; I think that they were your spin on them, Senator Joyce.

Senator JOYCE—He was talking about the—

CHAIR—In defence of the witness, I do not think that those were the words used by Mr Battellino.

Senator JOYCE—I refer to the comment about the reason why corporations want to go down this path being that they do not have to involve shareholders. That, I understand, means that there are transparency issues. The transparency that goes with public companies is lost once a public company becomes a private company. How are we going to get the transparency so that

you can make a value judgement about how this is acting in the economy without some sort of code of transparency?

Mr Battellino—There are two things to distinguish here. The first is the operations of the company. The company is going about its business, and that is fine. Most of what we have prepared here is not about the operations of the companies; it is about the funding of this particular form of investment. There is plenty of information available in the public domain on that; it is just a matter of putting it together. Financial markets are very demanding in terms of information.

Senator JOYCE—So you are saying that a lot of this debt has a strong caveat based requirement behind it.

Mr Battellino—What I am saying is that the investors who are looking to invest in these things want to know how the debt is rated, what is going on, how much of the debt has been issued. This information is all public. None of this information is gained from private sources. All this information has been put together from public sources.

Senator JOYCE—They want to have a key mechanism for monitoring that debt to make sure that they do not lose their money, don't they?

Mr Battellino—Yes.

Mr Broadbent—One of the things Ric was talking about earlier was the investment starting to move away from these covenant-light loans. So what happens in a debt instrument is that typically there are several covenants put upon them which would include, for instance, that a company may not be able to borrow beyond a certain gearing ratio. Those covenants are standard in contracts. What we have been seeing in the past year is several of those covenants being taken away and the debt instruments being issued as usual. Ric mentioned though that in the last few months, as credit spreads have started to move back up, some of those so-called covenant-light loans are not being accepted by the market. In other words, investors want a little bit more in terms of the extra protection that these covenants provide.

Senator JOYCE—My question is: are we starting to err away from a debt instrument towards a quasi equity instrument—that is, an instrument of control that is very prescribed on how this debt would be used?

Mr Battellino—I am not sure that I totally agree with that. All debt has always had restrictions on it.

Senator JOYCE—I know that.

Mr Battellino—This is just a continuation of that, basically. If anything, as John said, in recent years, because investors were feeling so confident, they were prepared to reduce the number of restrictions on that debt and now it is coming back up again.

Senator JOYCE—You talked about the involvement of private equity firms in the economy, but if we drill down in certain sectors, obviously there is more of a tendency for a strong

involvement in certain sectors than others. I draw your attention—although I probably do not need to—to the fact that, if the Qantas deal had gone through and we had had a graph of private equity involvement in the air transport industry, we would have gone from zero to hero in the space of a year. Have we drilled down in your figures to see where private equity is more likely to have an involvement and, with the lack of transparency that it then goes into that sector with, how that feeds back into the economy?

Mr Battellino—John might know a bit more about that, but we certainly have all the industries. There are not that many of these deals. How many deals were there last year? Twenty?

Mr Broadbent—Twenty-eight.

Mr Battellino—Twenty-eight deals is not a lot. We can track each one.

Senator JOYCE—If a private equity firm had taken over Coles—although I know it is not going to now—it would have ended up with 36 per cent of the retail market. That is a pretty substantial increase. It might not be substantial across the economy, but it is very substantial in one sector.

Mr Battellino—The question is: does that change the behaviour of Coles? We can see the financing of it.

Senator JOYCE—But you would not see the financing of it.

Mr Battellino—No, we would not. That is what I am saying. We do see the financing of it; that is all still public.

Senator JOYCE—But how would you see that after it becomes private?

Mr Battellino—We still see it because Coles is a private company and, if it goes to the market to issue debt, that is still in the public domain. That happens in public markets. The same figures that are in this document here are all public information. We do see all that. I think people are overestimating the amount of secrecy that happens here. The financing is all public.

Senator JOYCE—So you are saying that there is no intrinsic vulnerability. You have done a sensitivity analysis forward and, with the increase in debt, you do not perceive any vulnerability in any sections of the market by interest rates turning against people? Your own graph says that their leverage has gone right up, but, in the sensitivity analyses that you have done, you do not perceive any threat to certain sectors by their excessive debt loading on this?

Mr Battellino—We certainly do not see any threat to the banks, because the exposure of banks to this particular form of financing is very low.

Senator JOYCE—What if a private equity firm bought out a bank?

Mr Battellino—A private equity firm is not allowed to buy out a bank. The exposure of banks is very low. The overall exposure of the economy to this particular form of financing is quite

low. That is not to say that individual companies are not taking risks. That is a matter for the shareholders of that company.

Senator JOYCE—Why wouldn't private equity firms? I know they are not allowed to, but why aren't they allowed to buy up banks?

Mr Battellino—There are ownership restrictions on banks. There is a limit on what any individual can own on a bank.

Senator JOYCE—Why is that, because of a national interest issue?

Mr Battellino—No. It is a prudential issue because the last thing you want is a company basically setting up a bank to service itself. The banks are there as a vehicle to serve the public.

Senator JOYCE—So in certain sectors there are definitely national interest issues that need to be abided by in the marketplace?

Mr Battellino—Certainly for banking that is the case.

Senator JOYCE—That is one sector. Thank you very much for that.

Senator WEBBER—Like Senator Stephens, I would like to thank you for your overview. As someone that hasn't until now had to give these issues a great deal of thought I found it particularly useful. Can I go back to your graph No. 6 and get you to paint for me a verbal picture of what the year 2007 would look like if the Qantas deal had gone through.

Mr Battellino—Okay. The Qantas deal was—how much, John; was it—

CHAIR—Mr Battellino, I am sorry but just for the benefit of those who are sitting behind you can you just give an overview of that graph in response to the question.

Mr Battellino—Okay. So we have gone back to a graph that shows total private equity activity in Australia for each year for the last 20 years or so. The right-hand bars there are showing that we have had $14 billion of activity last year and a very similar level of activity announced this year. If the Qantas deal had slipped over into 2007—it was $11 billion—we would add $11 billion onto that 2007 figure, so that would take that up from $14 billion to $25 billion.

Senator WEBBER—So it would be a significant increase?

Mr Battellino—Yes.

Senator WEBBER—How do I compare that? I want to use my notes but don't hesitate to correct me if I have misunderstood what you have had to say. In your closing comments I thought you said something along the lines that it was very unlikely that the level of activity seen last year would be repeated.

Mr Battellino—Yes.

Senator WEBBER—So that is only really because one deal fell over?

Mr Battellino—No.

Senator WEBBER—Does that mean that we are not going to see another Qantas deal in Australia that would have such a significant impact on that graph?

Mr Battellino—My comment was mainly directed at the global picture, because you can see globally the source of funding for these vehicles is starting to dry up and the circumstances that gave rise to the surge last year have simply gone away, so that is the basis. A big deal can always come through and change the relative size of these bars. Nobody knows what is going to happen in the future.

Senator WEBBER—But that would be much harder to put together if the market is tightening up anyway?

Mr Battellino—Yes, it is getting harder to put those big deals together.

Senator WEBBER—Earlier in your comments you mentioned that the gap between debt and equity was starting to close, the issues impacting on that including the increased cost of debt and the increased costs in the American mortgage market, which would be their shifts in interest rates.

Mr Battellino—The main thing that is happening in the American mortgage market is not so much the increase in risk-free interest rates but in the premium that investors are demanding to buy those mortgage securities. As you know, the default rates on some of the so-called subprime mortgages in the US have increased quite a lot in the last year or so. Some of those mortgages are not being repaid and obviously the investors who bought the securities to fund those mortgages are now not getting their money, so they are demanding a much bigger return in order to keep buying these securities. That has spilt over into all other debt markets as well.

Senator WEBBER—Will we see a microversion of that happening in Australia with increased defaults in the Australian mortgage market?

Mr Battellino—No. The Australian mortgage market is actually quite different because the subprime market here, to the extent that it exists, is actually quite small. It is only about one per cent of mortgages and in the US it is more like 15 per cent. The default rates on Australian mortgages even in that subprime market remain very low so we have not seen the rise in spreads here that we have seen in the US.

Senator WEBBER—When the Qantas deal was put together there was a lot of media commentary about potential negative effects and how they may not been seen for a number of years, rather than straightaway when the deal is done. There seemed to be media commentary generally about risky private equity deals. Do you have any comments on that?

Mr Battellino—I suppose the answer is no, I do not have any particular comments. Obviously any group of investors who puts their money in is making their own assessment about risks and the returns they are going to get out of the investment. I do not have any particular insights—

Senator WEBBER—But the risk may not be immediately apparent; it may be one or two years or a number of years down the track before we discover it. I guess this also goes to where Senator Joyce was going.

Mr Battellino—Yes.

Senator BERNARDI—It comes back to the start of your presentation about the definition of private equity. You talked about venture capital and you also talked about leveraged buyouts. Do your figures include buyouts or transactions of large private companies or are they only to do with public companies and buyers?

Mr Broadbent—No, our figures include the large private companies. If a large private company were to purchase a large private company, in terms of gearing it up, our figures would include that as well.

Senator BERNARDI—You are telling me that there is really no significant difference between three or four businesspeople getting together and deciding to buy a private business and 300 investors putting their money into a private equity fund to buy a much larger private business?

Mr Battellino—I think that is right. Over time wealthy people have always had their own private companies. With financial innovation we have seen those facilities becoming available to the ordinary person because we develop vehicles that allow this investment to be pooled and for that money to go into private equity, in the same way that wealthy people have always done.

CHAIR—I apologise for interrupting, Senator Bernardi, but Senator Fielding has a commitment in a couple of minutes time and I would like to accommodate him.

Senator FIELDING—Thank you, Chair. In the March paper that you put together, *Private equity in Australia*, you covered—and quite rightly so—the area of taxation. There is a statement in there which reads:

> The implications for government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity on tax revenue.

What did you mean by that?

Mr Battellino—I should preface any comments I make here by saying that the bank is not an expert on taxation. To the extent you want to pursue this you need to talk to some experts. My own view is that the concerns about taxation and private equity are overstated. I think people are worrying unnecessarily because they are extrapolating from the micro to the macro in the sense that you can see a private equity deal and you can see that maybe they have found a way to reduce their taxes, but that is not the end of the story. The question is: what has happened to the capital that has been liberated by the private equity? How much tax are they paying? If I am the owner of some listed shares at the moment, I am getting my returns on dividends and capital gains and I am paying my tax on that. A private equity firm might come along and buy those and may find a way of paying less tax—and we will see about that—but the other question is: what has happened to the money I have got back from that investment? I have gone out and made

other investments and I am still paying my tax. You cannot extrapolate from one particular thing to a general macro picture. My conclusion would be that really, on a macro scale, shifts in the patterns of financing probably do not have a big overall impact on the tax base.

Senator FIELDING—The reason why I am focusing and homing in on that particular issue is that we are not talking about small amounts of money here. With the Qantas proposal that was put forward—on top of the changes which allow foreign companies to invest in deals like private equity and have capital gains tax-free status—over a five-year period of capital gains, using conservative numbers, you could be talking about $1 billion to the Australian tax revenue. You are not talking about small numbers there. So, as an Australian, I am concerned when I read a statement like:

> The implications for Government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity on tax revenue.

We are talking about numbers of $1 billion. This is a real concern. The issue that Family First have is that you have already got a potentially overheated market and, on top of that, the changes that the government brought in mean that foreign investors for the first time now can have capital gains tax-free status, which makes it even more attractive for private equity to come into Australia, and we have not even really done the blooming modelling! And we are talking about huge numbers of $1 billion.

CHAIR—Senator Fielding, with the greatest of respect, that was a series of statements. Have you got some questions for the witness?

Mr Battellino—Could I just say: the $1 billion is not the net figure; that is the figure for that particular company. The question is: how much tax has been paid by the people who previously owned Qantas? That money is still there. The money has not gone away; it is still there and it is still paying tax.

Senator FIELDING—It is awfully large numbers. I not having a shot at the Reserve Bank—

Mr Battellino—No.

Senator FIELDING—I am just saying it is a concern, because the Reserve Bank are very considered in what they say—and quite rightly so. Obviously this paper you have put together—and I will get to the question—

CHAIR—Can you move to the question, because I have to let Senator Bernardi ask his questions too.

Senator FIELDING—I understand, but this is an important issue. This paper was put together looking at private equity in Australia, and it is from the Reserve Bank. The Reserve Bank's statement is that there is currently insufficient data. Nothing much has changed from March until now. I just saying it is a concern. Aren't you concerned by that, Mr Battellino?

Mr Battellino—That statement is basically our way of saying that (a) it is not a Reserve Bank issue and (b) we did not think it was a big macro picture issue for us.

Senator JOYCE—The Treasury put forward figures of $65 million, $50 million and $50 million per year. Do you think that they are an appropriate reflection of the compromising of tax revenue or not?

Mr Battellino—I am not sure. I do not know the basis of those figures. I would have to go and look at those.

Senator JOYCE—You might take that on notice.

Mr Battellino—Okay.

CHAIR—Senator Fielding, do you have any further questions?

Senator FIELDING—No, thank you.

Senator BERNARDI—Going back, Mr Battellino: apart from the quantum, there really is no difference—other than perhaps the publicity attached—between a buyout of a large, medium or small publicly listed company and a large, medium or small private company. Am I right?

Mr Battellino—Yes. I think that is right.

Senator BERNARDI—The question then comes to the financing of this. If someone were to buy a private company, they would be entitled to borrow up to a prescribed limit according to the lending parameters and they would be entitled to exactly the same rates and benefits through the taxation regime as someone who was buying a larger company. Is that right?

Mr Battellino—Yes, I think so.

Senator BERNARDI—So it just comes down to the numbers, which tend to scare people because of the potential indications for the economy or particular companies.

Mr Battellino—Yes.

Senator BERNARDI—In some of your presentations there, you have highlighted the variability in private equity transactions over the course of the last 20 or so years. We have had higher peaks and lower periods of activity. In your judgement, is the market then self-regulating about the appropriateness and the risk attached to these transactions? Is it a sign that the market is working quite efficiently?

Mr Battellino—Broadly speaking I think that is right. I do not know if I would use the word ‘self-regulating’; I would use the word ‘accrual-regulating’. If some particular set of returns becomes unusually large or small, that will set in train the process that leads to its correction. I think we are seeing that. The last few years have been quite unusual periods in global capital markets because of the very low cost of debt.

Senator BERNARDI—Going to the debt, then, you talked about how Australian banks have a role in financing this. Do Australian banks generally securitise or offload their debt obligations?

Mr Battellino—I think this is probably something that you might follow up with APRA later because they are more in tune with what individual banks are doing than we are.

Mr Broadbent—In short, yes. They tend to be fairly limited players in these larger deals. Hence one of our pie charts showed that the majority of funds are coming from the overseas banks. We did mention a little bit in our FSR publication that the banks would take on debt initially. They would have a certain commitment to underwrite that debt. It would always be subject to limits. Then they would look to gradually take it off their books by, say, securitisation and just selling part of the debt off. As a result what has tended to happen—and that is why, I think—is that banks tend to have fairly low levels of these sorts of leveraged loans on their books.

Senator BERNARDI—In that same chart you also suggested that hedge funds are now providing the great bulk of financing. Does your description of hedge funds include superannuation funds and those sorts of vehicles?

Mr Battellino—The hedge funds are separate from the super funds, although the super funds do have some of their investments with the hedge funds, but it is very small—I think across the whole superannuation industry probably a couple of per cent or so of superannuation money is in hedge funds.

Senator BERNARDI—So it is not like Australians' savings are at serious risk?

Mr Battellino—No.

Senator BERNARDI—Is it because of liquidity? You talked about there being issues for tying up the bulk of capital in unlisted investments through liquidity.

Mr Battellino—That is right. I suspect the average superannuation fund trustee would be very reluctant to see a big proportion of their investments tied up in vehicles that might have a higher risk and might be quite illiquid.

Senator BERNARDI—Does that mean that, compared with, say, share market investments, private equity investments would be regarded as long-term investments?

Mr Battellino—I think that is right. When a small group of like-minded investors come together they are saying: 'Look, we've got a 10-year view here. We're putting in our money for 10 years and we're hoping we are going to have over that period a return that is higher than available on the share market. But we acknowledge that we're basically committing here for 10 years, whereas on the share market you only have to commit for a day.'

Senator BERNARDI—I will choose this word, but it might be the wrong word: you would not regard it, then, as a 'speculative' investment?

Mr Battellino—No, I do not think they are a speculative investment.

Senator BERNARDI—That is interesting. To come back to the comment that short-term performance sometimes hamstrings the returns for shareholders—the demands for it through the

public arena—would you regard less of a focus on short-term performance as being in the long-term interests of the Australian economy?

Mr Battellino—Universally, yes. Everybody agrees with that. The question is: how do you do it? We all want long-term performance, but we also want the performance to be good every day.

Senator JOYCE—The banks are ambivalent to the animal spirits of the market.

Senator BERNARDI—So the focus on short-term performance you think is potentially damaging shareholder returns? Or am I taking a quantum leap?

Mr Battellino—It is what capitalism is about, basically. It is a flawed system, but there is no better system. If somebody found a better system—

Senator JOYCE—I thought you were about to tell us what capitalism is about—and then we would have an interesting discussion!

Mr Battellino—Everybody complains about the short termism in equity markets. Private equity is one way to do it, I suppose, but basically human psychology is what it is.

CHAIR—I just wonder whether we might have the name of our report!

Senator BERNARDI—One of the interesting comments that you passed, among many, is that Australian public company boards are now looking to release some of the equity, I guess, and drive more efficient use of their balance sheets. Surely, in a modest manner, without going to the extreme and using prudence, that is a very good thing for Australian companies' shareholders.

Mr Battellino—One of the things about the capitalist system is that it is very competitive—it can be brutal at times—and it can go off the track at times but, on balance, it self-equilibrates. There is a group of people out there who thought that there was a case to take on a bit more risk in the corporate sector.

Senator JOYCE—The 28th of October 1929 was kind of brutal.

Mr Battellino—Yes.

Senator BERNARDI—The world economy has grown since then, though. I would like to put that on the record.

CHAIR—We are getting way off the terms of reference of the inquiry.

Senator BERNARDI—But it is working quite efficiently.

Mr Battellino—Yes.

Senator BERNARDI—Finally, I would like to come to a point about interest rates and to pick up on Senator Joyce's point about there being already two different rates—there are

corporate interest rates and the interest rates of government debt. You made the point that government has not been doing a lot of borrowing recently and this keeps interest rates low. Are you talking about the federal government or are there other government demands that might affect interest rates?

Mr Battellino—Certainly it is the case in Australia; the Australian government, as you know, has been running budget surpluses for quite a number of years now. While that is probably one of the best fiscal positions internationally, there has been a general reduction in government borrowing around the world. The US government went back into substantial deficit a few years back, but that has been narrowed again. The main thing is that there has been a very strong demand for debt instruments around the world. A lot of that has come out of Asia and particularly Asian central banks, who are looking to invest the massive build up of reserves that they have accumulated in recent years. So this is all helping to keep those risk-free rates down.

CHAIR—I want to look at a couple of matters—and for the benefit of colleagues, I am back at the excerpt from that financial stability report. In relation to the LBOs, you make the point on page 2 of the excerpt that, despite some of the frenetic commentary on this, we are not talking about increased numbers; we are talking about value, aren't we?

Mr Battellino—Yes.

CHAIR—Just going back to those who tend to be the major investors in PE, would it be fair to say that, given the involvement of the superannuation funds and others, it tends to be a more mature investor in private equity? I mean mature in the context of most likely having a level of knowledge about the risks and otherwise—sophisticated is the word my colleague has just used, which is probably a better one.

Mr Battellino—I do not think there is a big participation by retail investors in this field. I think the money is channelled into the institutional funds and from there goes into private equity.

CHAIR—Yes. Can I just take you to page 10 of that excerpt in relation to corporate conduct, in the opening section of that part of the report, and the application of the Corporations Act in relation to both corporate behaviour and requirements but also to licensing regimes and the requirements for advising others to be licensed. Can you just expand on that, please, because I think there may be a view that these transactions are not subject to the Corporations Act. Could you just elaborate on that for me, please.

Mr Battellino—I did say at the start that this document was the result of input from not only the Reserve Bank but also ASIC, the Treasury and APRA. This section here on corporate conduct would be mainly the reflection of ASIC's views, so, if you are dealing with ASIC later in the day, I would prefer to leave that matter for them to comment on, because I am sure they would be in a much better position to do that than I would be.

CHAIR—Sure. I am just trying to ascertain the differences between the Australian experience and perhaps the international experience. I take you to page 9, 'Depth and quality of public capital markets'. You say in the report:

Furthermore, in the United Kingdom, the inflow into private equity funds in the first half of 2006 exceeded new capital raised through initial public offerings (IPOs) on the London Stock Exchange. In contrast, in Australia $8 billion of new capital was raised through IPOs on the Australian Stock Exchange in 2006, compared with inflows into private equity funds of $3 billion.

Are you able to enlighten the committee on why you think there might be that difference in emphasis? Is it a historical matter? Why was that likely to be, do you think?

Mr Broadbent—The point we were looking to make was that there was, at the time, various commentary, particularly overseas, that private equity was taking too much out of the public domain and therefore there was an intrinsic problem of moving large amounts of the corporate sector into private hands. Our comments were simply based on this: that in our case it could not be much further from the truth, simply that you had a much greater number of IPOs—in other words, new entrants into the public arena—than those that were being taken or potentially being taken out from the public arena and that, at the time, we were just looking at the level of new funds into the stock market vis-a-vis those funds of inflows that were going into private equity funds—in other words, funds that could be used to purchase a public or a private company.

CHAIR—Finally, looking at the ‘Conclusions’ section on pages 14 and 15 of that excerpt, with the roles of ASIC, APRA and your organisation, there is no recommendation that there be any legislative or regulatory changes required. Is that your position?

Mr Battellino—The main responsibilities are with ASIC, I suppose, and that would be something to pursue with them. But my feeling is that I am sure they would claim that the private equity vehicles are subject to the same sort of general corporate law issues that the public companies are. But, as I say, that is an area that you should probably talk to ASIC about.

CHAIR—Is your view from the RBA that there should be any regulatory or legislative changes to address any of these issues raised in the—

Mr Battellino—No, I think that from our point of view we certainly do not see a case for regulatory change in this area. As I say, it was the outcome of a very unusual set of circumstances. Those circumstances are closing, and I do not think there is a lasting problem here at all.

CHAIR—Finally, by way of clarification—and it is probably stating the bleeding obvious, but for the sake of the public record I will ask the question—your financial stability report, particularly in relation to private equity, was not in any way motivated by this inquiry or by any other inquiry?

Mr Battellino—No.

Senator WEBBER—You made some comments earlier about increased Asian investment and activity. I am wondering, therefore, if I could get you to comment on how resilient the private equity market is in Australia to any sudden change in economic circumstances in places like Asia, such as the shocks we saw in the 1990s.

Mr Battellino—There are two things to consider. One is existing private equity investments. I think they are fine because basically when investors look to put these things together they usually lock up the money for the period they want. The question is: what happens to the new, potential investments coming along? I am sure that, if there were some shock in the world, those investments would be more difficult to come by. That is what we have seen in the US recently where subprime mortgages have impacted on this market here. Similarly, if there were something happening in Asia, the same thing would happen.

Senator STEPHENS—Mr Battellino, the committee has been provided with two opinion pieces from Standard and Poors which articulate quite serious concerns that that agency has with the way in which LBO financing is operating at the moment. I do not know whether you have seen these documents. One called *Leveraged buyouts in Australia: Who really bears the risks*, expresses concerns about the risks and the potential exposure for subordinate or hybrid debt, particularly for mum and dad investors. Does the RBA have a view about the concerns that the rating agencies make about this issue and about the fact that their opinion is that subordinated retail instruments are typically unrated and that mum and dad investors—such as those in superannuation funds—can be exposed to levels of risk they do not understand?

Mr Battellino—The debt for these things is structured into various tranches. There is no doubt that the bottom of the debt, which is the part that will initially bear any losses, is the most risky. I do not think this is a big problem because this is not a market where the retail investors play a direct role. It is not like the debenture market, for example, where the average pensioner is going straight in and buying his debentures. This is a market basically where it is sold mainly to institutional investors. It is true that the average person has money invested through their super fund but there are two layers of control over that money: one is where the trustees of the super fund are limiting the amount of money they put into this particular type of instrument and, second, the trustees are then hiring a professional funds manager to manage that money, subject to guidelines drawn up by the trustees. So there is a fair bit of control over this. My impression is that because of the professional nature of this investment, most of these funds would understand that this is a more risky form of investment. That is why they tend to keep these investments at the margin.

Senator JOYCE—You do not believe that there is any need for any regulatory change. Is that your statement?

Mr Battellino—From the Reserve Bank's perspective, it could be that ASIC is more in tune with the regulations of the corporate sector. They may see something there. But, from our perspective, as a general macro picture, I do not think there is anything worrying the Reserve Bank here.

Senator JOYCE—But you are aware of other parts of the world where they do have concerns?

Mr Battellino—The thing that happened last year was that—

CHAIR—Would you keep this answer short because we are about to finish.

Mr Battellino—Sure. Many very high profile companies became the target of LBOs and that caused a lot of public concern because of which companies they were. That has caused a backlash, so to speak, where people are worried that these things are being taken over by private finance companies and that there is something wrong going on here. The main thing is that some people want more regulation and others are saying that there needs to be more transparency. But you cannot divorce that from the fact that it is specific to the companies which are being taken over, because many of them are household names.

Senator JOYCE—You have a different view from the view that has been espoused about such things as the takeover of the Oregon utilities organisation? There is another one going on. Are you aware of those?

CHAIR—Senator Joyce, Mr Battellino has put the RBA’s view in relation to Australia and that is where this inquiry is at.

Proceedings suspended from 10.31 am to 10.48 am

COOPER, Mr Jeremy Ross, Deputy Chairman, Australian Securities and Investments Commission

RODGERS, Mr Malcolm, Executive Director, Regulation, Australian Securities and Investments Commission

CHAIR—Welcome. I will not go through my introductory statement again. I assume, gentlemen, that you have appeared before sufficient committees not to need the chair's guidance in relation to these matters. Do you wish to make an opening statement?

Mr Cooper—I wish to make a short opening statement and I seek leave to hand up a short written text.

CHAIR—Please proceed.

Mr Cooper—To assist this inquiry I want to start with a summary of our view on private equity and then provide a few statistics on the current size and shape of the private equity market. Firstly, we think that the regulatory regime which ASIC administers, which is across this landscape—consumer protection, financial services licensing, scheme registration, product disclosure, market trading, takeovers and corporate behaviour—has coped adequately with current levels of private equity activity in Australia. The scale of private equity in Australia is still relatively modest and so concerns about risks and possible harm to the financial system need to be put in proper perspective. I will give a quick summary of those statistics.

Overall, the arrival of private equity in Australia has been a healthy development. It is a globally recognised alternative asset class that should be available to Australian investors, subject to the existing regulatory regime, which I have outlined. Australian institutional investors have been forced to focus more closely on the value of their investments in listed entities—and we have seen a few examples where that has occurred—and capital has been allowed to be allocated by market forces, with corresponding increases in equity market liquidity, and value-added to underlying businesses. We have seen in the newspapers today a private equity transaction that seems to be a model of that kind of thing. So, as things currently stand, in our view, there is no need for new regulation or increased powers for ASIC—

CHAIR—For the benefit of everyone, can you identify what that transaction is that you are referring to and where you saw it?

Mr Cooper—Certainly. It was the Chanticleer article, dated 25 July. It was a transaction between AMP Capital Investors, as the vendor of a business called Total Eden-McCracken, and listed company Alesco was the purchaser. So, as things currently stand, there is no need for new regulation, or increased powers, for ASIC to deal with issues arising out of private equity activity in Australia. However, it is a fast-moving landscape and this view is also subject to the outcome of our closer examination of the risks facing retail investors, in particular, which was one of the six regulatory priorities outlined to this committee on 30 May this year.

I have some observations about the landscape. Private equity funds, as most people know, principally target wholesale investors. Retail investors generally only get indirect exposure through their superannuation funds. Research suggests that Australian superannuation funds are aiming to maintain about a four to five per cent exposure to private equity. A number of funds would not yet have reached this target. Total private equity funds under management in Australia stood at around $22.4 billion as at 30 June 2006. I understand the current figures are about the same. Last financial year, new equity raisings on ASX were approximately $61.46 billion and PE raisings—that is the amount of money raised by private equity funds—was $4.1 billion. That gives you an idea of the proportion. So, overall, private equity seems at this stage to be a small component of Australian equity markets.

For example, during 2006 the total value of all PE deals announced and endorsed by target boards in Australia was estimated at about $25.67 billion, while the total value of the listed domestic equities market was some $1.39 trillion at the end of 2006. Private equity transactions therefore represented about 1.75 per cent of the total value of the listed equities market at that time.

In a survey of Australian capital markets, which was released only last week, KPMG said that about $6½ billion was expected to have been raised in the financial year just ended. KPMG also estimated that some $65 billion in new equity was raised in the same period. Based on those figures, private equity raisings amounted to 10 per cent of the total equity capital raised on the ASX. That concludes my opening statement, and I will hand up copies for committee members.

CHAIR—Do you seek leave to table those, Mr Cooper?

Mr Cooper—Yes, I seek leave.

Senator JOYCE—You have said that, basically, the ship is sailing as it should and that everything is under control. I refer you to the UK and its code of conduct on the level of disclosure. What ongoing supervision do you have in comparison to what is really an island—that is, England—with a bank on it? How do you compare what they are doing to what we are doing?

Mr Cooper—Is the code of conduct you are referring to the Walker report recommendations?

Senator JOYCE—If that is the one from the UK, yes.

Mr Cooper—The key observation to make about private equity in Australia is that it is already quite comprehensively regulated by our regime, because the financial services regime is a scalable regime that applies to all manner of different types of financial product and private equity fits in with the existing regulatory model. Similarly, in relation to the disclosures that private entities need to make in Australia, we have quite a high level of disclosure obligations that apply to entities, even those that are not listed on the Australian Securities Exchange. That is a very big difference between here and the United Kingdom. In this country we rolled out the IFRS accounting standards pretty well right through the system. Unlisted public companies and large proprietary companies have quite comprehensive disclosure obligations. The expression ‘going dark’ has been used in relation to private equity. It is not so easy to ‘go dark’ in Australia.

Senator JOYCE—So what you are saying—and I am actually inquiring on this—is that we have the capacity to cover up that dark side because we have an excess of regulatory requirements that the UK does not otherwise have; is that your statement?

Mr Cooper—We believe that is right. This report has only come out last week—the Walker paper—but our quick assessment of it is that there are differences between here and the United Kingdom. I would not call it excessive regulation. I just think we have a certain level of requirements for financial reporting on unlisted entities. That has been in existence for some time, but it just provides an interesting distinction between our system and the UK system.

CHAIR—I did not realise that you thought we had excessive regulation, Senator Joyce.

Senator JOYCE—No, I was just referring to a question: the differentiation between the Walker report, which does have a code of conduct to get at greater transparency, and what we do not have here—and now we have heard it twice. I want to draw your attention to another area: that of conflicts of interest, especially regarding management lockouts. We have seen in the failed private equity bid on Qantas the $300 million incentive package that was in for the directors to come up with one particular outcome and not another. I want you to tell me whether you believe that is a conflict of interest and, if you do, what you intend to do about it in the future.

Mr Cooper—I think more or less all participants accept that there is a conflict of interest. The issue is whether it is managed properly. In the case of Qantas I think there was quite clearly a potential conflict of interest, but the reality is that that conflict was well known by Qantas and its advisers. They set up protocols whereby the management who were to receive that remuneration if the bid were successful were isolated from key decisions that were made in relation to the bid and, in fact, the regime that was set up and implemented is not unlike the guidance that was subsequently issued by the Takeovers Panel. I think it is guidance note 19 which talks about insider participation in control transactions. What you see in that guidance is very similar to what Qantas worked out for itself, with the help of its advisers, to isolate the two key executives considering the bid from deciding whether or not to recommend it to shareholders and so on. We were closely involved in checking to see that Qantas had properly managed that conflict right through the process.

Senator JOYCE—This is the query: do you think it is right or it stands proper examination that the party that is deemed to be in a conflict of interest be the primary instrument for setting up the protocols to deal with that conflict of interest?

Mr Cooper—No, I do not think that is quite right. I believe the chairman and other non-executive directors with the help of Qantas advisers were the ones who set up the protocol, not Mr Dixon or Mr Gregg.

Senator JOYCE—But it is within Qantas. You would have to say it was within the castle of Qantas. They were predominant drivers for the protocols for dealing with their own conflict of interest. I will give them the benefit of the doubt on their character, but from an examination from a third party one would have a huge question mark over that, wouldn’t they?

Mr Cooper—There is no doubt that these transactions are challenging—the amounts of money involved are definitely material—

Senator JOYCE—And $300 million is material. If you found that lying on the floor of a pub, you would pick it up.

Mr Cooper—and they do put pressure on directors and their advisers to manage these pressures. Having said all of that, we are satisfied that there is not much else that could have been done in the Qantas example to manage that conflict.

Senator JOYCE—Could have been done then, but envisaging that this may be the case into the future, you could be a bit more succinct about how these issues are to be dealt with.

Mr Rodgers—As Jeremy has acknowledged, there was a conflict. There are two ways to deal with that conflict. One is to make sure that it was fully disclosed—and I think that had happened; the market was aware right from the beginning of the transaction about what the overall arrangements were. The other necessary way to manage these kinds of conflicts effectively is to put in place arrangements so that the decision makers on the deal are free of that potential for conflict. I think that is what we are saying occurred in the Qantas case. I can think of at least one other case where those arrangements were not so well disclosed or managed in that way until the market had reacted.

Senator JOYCE—Obviously it is the duty of stewardship of the directors on behalf of the shareholders that is called into question. The price of Qantas has actually gone beyond the bid price—or certainly did. So, in hindsight, that is a big issue.

CHAIR—Senator, I do not think the officers can comment on those matters.

Senator JOYCE—Okay, I will go onto another area. In that case, do you have a dedicated unit dealing with private equity firms?

Mr Cooper—No.

Senator JOYCE—Do you need a dedicated unit to deal with private equity firms?

Mr Cooper—No, we do not, and I think for the reason I have outlined before: private equity is just one form or one way of pooling together investors, purchasing assets and seeking to create value. That is one of the good things about our regulatory system: it is flexible and can deal with private equity without having to write a new chapter of the Corporations Act for private equity. Private equity has features about it that are very familiar. One of the ideas floating around is that there is a convergence going on so that ideas from private equity are being used by other asset managers. We are seeing in the United States some degree of convergence between hedge funds and private equity, and the traditional managed fund is structurally not unlike private equity. Naturally, we are researching. As work that other regulators are doing comes out, we are looking at it and so on. We are trying to keep ourselves very up-to-date with private equity, but have we set up a special division for private equity? No.

Senator JOYCE—As you are keeping yourself up-to-date, can you give us a brief statement on what is happening overseas in regard to conflict of interest as compared to what is happening in Australia?

Mr Cooper—I think it is fair to say that we probably have a more comprehensive and advanced regime on conflict than pretty well any other jurisdiction. The reason for that is that our government decided that the conflicts obligation would be a principles based one and it would apply to all participants who had a financial services licence. They have an obligation to manage conflicts properly. That approach has not been universally taken up in other jurisdictions. The United Kingdom would possibly be the closest. You will be well aware of the Financial Services Authority's two recent works on private equity—one in June last year and another one in June this year. Of course, the FSA is a different regulator. It has a prudential supervision role as well, so a lot of the issues that it talks about and looks at are looking at it from the banking system and lending side rather than the corporate side.

Senator JOYCE—Do you have any issues about private equity in Australia?

Mr Cooper—Yes. We make no secret of the fact that private equity does carry some degree of risk. All business enterprises do. So as a consumer protection regulator we are very watchful to see to what extent the risk attaching to private equity gets exposed to consumers. The overall summary I have given is that, given the size of private equity in Australia and where the activity is, currently we do not have a sufficiently heightened degree of concern to be recommending further powers or new regulation.

Senator JOYCE—I will just add one more thing in there, because you just need to answer it yes or no: does that include the investment of Australian citizens' superannuation into private equity?

Mr Cooper—Yes, it does.

Senator JOYCE—Okay, thank you.

Mr Cooper—And the reason for that is that there is a quite complex regulatory regime sitting over superannuation. The trustees of superannuation funds have fiduciary duties, are regulated by the SI(S) Act, and they have access to possibly the best advice on asset allocation and other types of specialist advice in the world. While there is risk attaching to private equity investment, in some respects it lends itself to superannuation because it is typically a longer term investment. So there is risk, but we say that superannuation funds should be in a good position to be able to assess what those risks are and how much of a fund's assets can be put into private equity.

Senator JOYCE—That is an issue.

Senator STEPHENS—Thank you, gentlemen. This has been a topic of great interest and certainly a lot of public commentary. One of the messages consistently through many of the submissions is a claim that there is a very heavy regulatory burden on listed companies and that this is one of the reasons why people are moving to this private equity structure. I wonder if you can provide the committee with any evidence that compliance burdens might be a major factor in driving this shift to private equity investment and perhaps comment, if I can ask a double-

barrelled question of you, on the claim made by the Australian Institute of Company Directors in their journal in companydirectors.com.au about private equity:

Another advantage that private equity has over traditional public companies is that they do not have to publicly disclose their periodic financial results. In addition, the introduction of the new international financial reporting standards is also causing some unexpected complications.

That is on page 39 of our briefing notes. I do not know if you have these papers.

Mr Cooper—No, I do not think we do, Senator. Not to worry, I will answer your double-barrelled question. I might get Malcolm—

CHAIR—Senator Stephens, perhaps Mr Cooper should be asked whether he agrees with the proposition first and then to comment on it.

Senator STEPHENS—He can tell us that.

Mr Cooper—As a regulator, you are not going to be surprised to hear from me that I do not agree with the proposition. There really is currently no decent data to support what is really rhetoric and anecdotal commentary. In fact, a study Professor Ian Ramsay was involved with over quite a lengthy period of time looked at why companies delisted—in other words, left the listed market—and there was simply no evidence to suggest that the burden of regulation was wearing people out and forcing them to make a pretty extreme decision to leave the listed market and go private purely because of regulation.

It is true that taking yourself off the listed market does give you more freedom. It is a trade-off. If you want money from the public and you want to be on a public market, not surprisingly there is a level of regulation about that. That is commonsense. But to turn that proposition around and say that people will actually leave that market because the regulation is too burdensome is simply not supported by the data.

Also, people are forgetting that private equity works with relatively high levels of debt. You might move into a slightly less regulated environment by leaving the listed market, but when you owe a banking syndicate some five or six times the annual EBIT that you are producing it is quite likely that they are going to be focusing pretty heavily on what you are doing. In other words, a new type of regulation will build up. It is not the listed market and the regulator this time, but it is people who are very keen to see that things are being done properly—in other words, the banks who are owed all the money. It is largely rhetoric. Malcolm, do you want to help on the accounting side?

Mr Rodgers—To put it in concrete terms, if a company that is currently publicly listed and traded on the ASX goes private it is still a large company. What are the differences in the obligations for that new private company? It is not bound by the continuous disclosure rules that apply if you are listed on the ASX. It does not have to lodge half-yearly financial reports. It still needs to lodge an annual financial report, but some of the disclosures that the Corporations Act requires in annual reports do not apply to it. Perhaps the most striking of those is the disclosure about director and executive remuneration. But it is a mistake to think of the move from publicly to privately listed as being a move from regulated to unregulated, because those are the only

three differences for a large company. Arguably, they are disciplines that ought to apply in a publicly listed market. I suppose it is more than just about complying with regulation. The market places quite different disciplines on publicly listed companies than those it places on private companies, because the market is not directly involved in private companies. No doubt that combination of having to tell the market what is going on and the market responses to that are sometimes seen as burdensome by publicly listed companies. But I do not buy the argument that there is such a difference in what you are required to do by regulation and that that alone would look like a motive for moving from public to private.

Senator STEPHENS—The second part of my question was about the introduction of the new international financial reporting standards. Do you have a comment to make on them?

Mr Rodgers—I understand why that is likely to be said, because a number of companies who have moved from the old Australian accounting standards to the international standards have found the transition somewhat troublesome. With all due respect to the submission that you have in front of you, that is entirely irrelevant to this debate, because those financial reporting standards will apply to a large unlisted private company in the same way as they will apply to a public company. There is no difference between the accounting standards that apply to a private equity firm that has reporting obligations under the Corporations Act and those that apply to a public company. I suspect that that is an opportunity to tell you that not everybody is happy with the move to international financial reporting standards rather than a particular commentary on private equity.

Senator BERNARDI—Following on from that and the regulation aspects, is it fair to say that in the listed company environment the reporting obligations of half-yearly reports and so on are designed to protect disclosure to retail investors and also to meet the demands of professional fund managers who invest in these companies and have to put in their quarterly returns?

Mr Rodgers—That is true, but I would put it slightly differently. Those rules are intended to make sure that the trading that takes place on public markets is as fully informed as possible. That protects all of the users of that market. It is primarily on the basis that trading on public markets should be based on those who are trading having full knowledge of information that might affect their decision to buy or sell.

Senator BERNARDI—Exactly, so that they can invest their money wisely and protect their capital and things of that nature. So if there is a lower disclosure regime—I would not say regulatory regime, but it is partly that—for private equity deals, because they are private companies, it would be fair to say that if you have two or three billion dollars of your own equity at risk, you are going to monitor that equally as well, aren’t you? It is not like they are not without an investment in these businesses.

Mr Rodgers—Let me agree with that again by putting it slightly in another way, and seeing if it is the same thing. The investors in a private equity situation have exactly the same incentives to monitor information about their investments as investors in public markets; it is just, arguably, that they don’t need a public disclosure regime in order to be able to do that.

Senator BERNARDI—I think that sums it up. I will come back to risk in a moment. I would like to pick up the conflict of interest issue that Senator Joyce raised. Where conflict of interest

is a legal issue—I would guess at most levels—is ASIC in a position to intervene if it believes a conflict of interest is not being managed appropriately?

Mr Cooper—It certainly is, yes. There is nothing special about private equity in relation to conflicts of interest. Because you have a large amount of players in private equity, conflicts can come up. Senator Joyce has spoken about target executive conflicts. The fund managers themselves can have conflicts between their own interests, the fund members and the company they are investing in, for example. Financiers can have conflicts in relation to transactions. So there are conflicts at all levels. Certainly if we are talking about director conflicts and financial services licensee conflicts, then ASIC has full jurisdiction. There is absolutely no magic about it being a private equity transaction, as opposed to some other type of transaction.

Senator BERNARDI—So what sorts of interventions could you take?

Mr Rodgers—There are two layers, as Jeremy is saying. There is the potential for conflict at the director and officer level. Let us talk about a typical leveraged buyer. For the directors and officers of the target, the obligations that bind them are the obligations that apply to directors and officers of corporations and there are a variety of possible mechanisms, including criminal mechanisms. The normal tools that we use to deal with departures from legislative standards of behaviour by directors and officers are all fully available in these circumstances: civil action, seeking to ban directors, and in extreme cases seeking to commence criminal proceedings. That includes all the normal protective mechanisms that sit behind those things—the ability to get a court to make a particular order requiring a person to behave or stop behaving in a particular way and so on. On the licensee side, which really largely applies to the advisers, those who hold Australian financial services licences, we have all of the quite large array of remedies that we have available to deal with breaches of obligations by financial service licensees; it pretty much looks the same kind of suite. We can intervene at an early stage and get court orders requiring people to do something or stop doing something. We can take action against the licensee to limit its licence or, in extreme cases, to remove its licence. Hence the proposition we made at the beginning of this—that we see no need for changes to the regulatory regime or of our powers under it.

Senator BERNARDI—I go back to risk now. You talked a little bit about risk. You obviously do not believe there is a regulatory risk, based on some of the other evidence you have given, so what is the risk of private equity? Is it simply leverage?

Mr Cooper—Purely and simply, I guess that is the biggest risk. If you were going to ask what the single biggest difference is between private equity and other forms of collective investment, the leveraging is the stand-out difference. There are other factors but, on the negative risk side, leverage is the difference.

Senator BERNARDI—Given that private equity is principally for sophisticated investors or institutional investors who can or should be able to adequately assess risk, are there retail products available outside of private equity that include leverage—financial products, such as investment funds that borrow money to invest in the share market or funds that have derivative exposure, that are available to retail investors?

Mr Cooper—Yes, there are. There are really two species. I will start with the equity side. If you want to be an owner in a private equity fund in the retail sense in Australia, you do have the ability—and we think this is perfectly appropriate—to access those sorts of products. I will give you a couple of examples. The Colonial First State Group operates the Colonial First State Diversified Private Equity Fund, which has been around for five or six years, as I understand it. It has about 1,500 retail investors and, as far as we can see, it has been an entirely appropriate and successful vehicle for those investors to be in. ING currently has another product which is effectively a fund of fund products. They allow access to about 11 other wholesale private equity funds. That shows you how retail investors, through funds management products, can have exposure to what I call the equity side—being an owner.

On the debt side, where a private equity transaction occurs, the debt is often in tiers. You have senior debt and junior debt and subordinated debt and so on. There are examples of where some of that debt gets securitised—in other, words chopped up into bite-size piece—and then sold to consumers. An example of that is the Myer notes transaction which took place in around August last year where the second ranking or subordinated debt in that transaction was marketed back to consumers.

Senator BERNARDI—Mr Cooper, I appreciate the information, but my question was specifically about outside of private equity. There are any number of managed funds that invest in listed equity investments or in any other investment class. Are there leveraged managed funds that will borrow on top of what their contributions have been?

Mr Rodgers—Let me answer that. Yes, there are. There are a variety of other ways in which retail investors are invited to leverage investments. There are a range of products. What comes to mind, for example, is contracts for difference, which are effectively, in some cases, quite highly leveraged exposures to equity products. The kind of exposure to leveraged products that a retail investor can have is not in any sense unique to private equity investments.

Senator BERNARDI—That is what I am coming to. We have managed leveraged investments reasonably effectively for retail investors over time. The difference with private equity is that the amounts can be quite large and the companies can be household names. It is not like retail investors are at any greater risk than they have been with other products that have been available for many years.

Mr Cooper—I am sorry; I misinterpreted your question before.

Senator BERNARDI—I liked the information you gave us anyway.

Mr Cooper—I completely agree. There are a lot of products out there with what they call embedded leverage in them—instalment warrants; vehicles where there is a lot of debt involved in the way that the company runs the business. Some of the infrastructure investments available to investors have a lot of leverage in the way that they operate. I will, though, just make one important distinction. From where we sit, investors seem to get confused about so-called fixed interest investments. So, for example, if I look at the way retail investors invest in all manner of products that we have talked about, the way they participate in the ASX market, they understand that, when you invest in a business venture, there is a degree of risk. Even if the product is quite complex, I think that the average retail investor understands that there are risks involved.

When you come over to the fixed interest side of things—and we have seen this with the Fincorps, the Westpoints and so on—there is sometimes a great degree of confusion in that in fact a fixed interest investment can carry a significant amount of risk and, in some cases, a complete loss of capital. So, when a private equity product is translated into a fixed interest investment like I was talking about earlier—subordinated debt that comes with a brand name and is a fixed interest investment—I think there is some risk there that consumers will misinterpret or misprice the risk that is involved and merely take at face value that it is a fixed interest investment and therefore you cannot lose your money and you are going to be paid that level of interest.

Senator BERNARDI—We both know that is not true—

Mr Cooper—We do indeed.

Senator BERNARDI—in that we can lose the money. But there are a number of fixed interest or floating rate unsecured notes and things that are available directly on the Stock Exchange as well; it is not limited to unlisted investments, is it?

Mr Cooper—There are. I think having those products listed is a very great way down the track, because then you have people who rate those products, and you have a market that is pricing what the product is doing. So, when you have a fixed interest product that is actually listed, you have all of the disclosure obligations, the market pricing, and so a lot of those problems are overcome.

Mr Rodgers—And, in effect, listing provides people with liquidity so that they have an exit mechanism that is not available to them—or certainly not as readily available to them—if they are holding an unlisted product.

Senator BERNARDI—In an unlisted debt product, just for clarification, such as the ones you mentioned—I did not write them down—are they generally for fixed terms, or is there a measure of liquidity available through some of these funds?

Mr Cooper—There is a combination. Some of them are at call; some of them are for periods. Typically, what happens is that there is a fairly high rate of rollover, if you like, so an investor invests for six months, and at the end of those six months they roll over again and so on.

Senator BERNARDI—But, in the hypothetical $10 billion transaction, it is unlikely that one of these unlisted retail debt funds is going to allocate more than is prudent from its investment reserves, whether it be three per cent, five per cent or 15 per cent—whatever is its mandate—to that single transaction. I guess it is just the market at work.

Mr Cooper—It is.

Mr Rodgers—With the qualification that it is not unusual in a private equity transaction for the debt that is taken on initially by banks or investment banks, as Jeremy said, to be securitised and spread throughout the market by being repackaged and sold, including to retail investors—and we have not seen a lot of this in private equity transactions, but we have seen some in Australia, where ordinary retail investors hold some of that securitised debt. I think the point that

Jeremy was making is that sometimes the debt structures are fairly complex. Our vigilance is on the quality of disclosures that go into the prospectus that is made available to retail investors as the way for selling that debt.

Senator JOYCE—You are saying the debt is caveat heavy?

Mr Rodgers—It is not so much the caveats; it is the ability, again—I am in a sense repeating what Jeremy is saying—of the disclosure documents to really inform retail investors about what degree of risk sits with the debt, which will depend on how complex the transaction is. It is not so much the caveats, but it is where it ranks in the system, what security attaches to that particular debt offering and so on.

Senator JOYCE—Who is assessing the risk—

Senator BERNARDI—I have one more question, and it goes back to risk. An increasing number of private equity deals have been taking place over recent years in the Australian environment. There have been quite a number of corporate collapses of listed companies. Do you know how many companies that have been taken over by private equity firms have been put into administration or liquidation?

Mr Cooper—We might have to take that on notice to give you an absolute answer, but certainly none spring to mind.

Senator FIELDING—What about Ansett?

Senator BERNARDI—Ansett was not a private equity deal. You can take that on notice.

Mr Rodgers—I think there is a partial answer in the financial stability report, because there is a list there that includes some of the failures. But we can certainly have a look at that. It may be that other witnesses you talk to can more readily provide that than we can.

Senator WEBBER—I initially wanted to return to one of your comments, Mr Cooper. I was trying to take notes, so correct me if I am in any way verballing you. But you said something along the lines of, ‘If you want money invested from the public then you need to be listed.’ There is nothing more public to everyday people like me than a superannuation company. That is where my money is. So in fact if it is the superannuation companies that are financing private equity then it is public investment.

Mr Cooper—Yes. I do not want to get too abstract or philosophical here. When you look at all investment markets or ownership, ultimately human beings like us own the entire system. Superannuation funds and corporations are just legal constructs. They do not actually exist in reality. Ultimately our citizens own everything.

Senator WEBBER—Indeed, but for most of us the only significant financial investment we have is our own home and our superannuation.

Mr Cooper—Correct.

Senator WEBBER—That is it. We are, to use the term, relatively unsophisticated. We do not have any other exposure. Hence the public accountability that goes with what is happening with your superannuation money.

Mr Cooper—Correct. I would not like to come across as not saying that is a very serious endeavour. What I am saying is that we have a quality regulatory system, and the people who are looking after that money are in the best place to make decisions—with advice and with all the duties that they have—about where our superannuation savings go. I think as you travel around the world the Australian superannuation story just gets better and better. I suppose I am saying that private equity is a recognised alternative asset class around the world and is entirely appropriate. It would be entirely inappropriate if for some reason Australian savers were blocked out of that style of investment. Given the data that we have at the moment, we believe that the regulatory system around superannuation is proportionate to the amount of money that superannuation funds are spending on private equity.

CHAIR—Around five per cent, isn't it?

Mr Cooper—Around five per cent is the aim, but when you run the numbers quickly it is reasonably obvious that a number of funds either are not doing that at all or have not reached the five per cent yet.

Senator WEBBER—Do ASIC have any concerns and have you noticed any change of behaviour? We talk about publicly listed companies and the degree of accountability that goes with them. Has there been any shift, in terms of the people that are putting themselves up to be directors of companies, away from that very public exposure of being a director of a publicly listed company and into private equity?

Mr Cooper—Certainly there is anecdotal evidence, and there is no question that private equity has placed a lot of pressure on the governance and disclosure obligations of listed company boards. There is no doubt about that. ASIC does not have any really concrete data. Obviously private equity in this country, in the scale that we are seeing at the moment, is a relatively recent occurrence. But anecdotally there is no question that directors have had pressure put on them. When to disclose a proposal has been a big issue. There is also anecdotal evidence that in fact that pressure, although difficult, has been quite positive. I do not want to engage in speculation, but there is certainly a view around in the market that the private equity experience that Qantas had has not been unhelpful in relation to where the business is currently pointed, the share price and so on. That is really just me speculating, but there is a view out there in the market that it is not entirely unhealthy.

CHAIR—Don't speculate, Mr Cooper, because I will have 10 questions from people who will want you to speculate on some other things.

Mr Cooper—To countervail that, there is good pressure and bad pressure, if you like.

Senator WEBBER—Has ASIC observed any significant increase in defensive behaviour from publicly listed companies to keep private equity away?

Mr Cooper—Again, anecdotally, there has been talk about the classic strategies that a target board might undertake and those are to gear up the balance sheet in advance of an arrival of private equity or to undertake some very large transaction. Having said that, we do not have any concrete data of that sort of behaviour occurring across the landscape.

Senator WEBBER—We were talking about the media commentary before. Some of the commentary has been that when you allow private equity investment it can sometimes take two or three years before you see the negative impact, because there is only annual reporting rather than constant public accountability. Is that of concern?

Mr Cooper—It depends on the model that is adopted. Typically, if you look at the way these funds are structured, often there is not just one asset in the fund. You might have a number of assets or the investment might be done through a number of different funds so you get a level of diversification in relation to your investment. But there is no question, in relation to the question you put to me, that if the investment is just in one asset then because of the size and nature of that then it could—and Warren Buffet is quoted as making this sort of observation—take some time for an investor to realise that the investment was not performing properly and that at that point there is not a great deal of liquidity in terms of exiting that investment. But that is not always the way that private equity is structured.

Senator FIELDING—I have a couple of areas to pursue. With regard to the Australian Accounting Standards Board, a government body, and some of the comments it has made—and I know you are ASIC and that is a different body, but I think this is relevant—how do you react to the Australian Accounting Standards Board saying that there are major gaps in the Corporations Act and that, if a private equity investment were conducted through a trust and it did not involve the issue of securities to the public, it would not have to present financial reports regardless of the economic significance of the sale? That is in their submission. You have been talking about how wonderful the reports are under the Corporations Act. Do have any comments on that?

Mr Rodgers—It is precisely because they are reports under the Corporations Act. To have reporting under the Corporations Act you either have to be a corporation or be a managed investment scheme. Not only are Jeremy and I from ASIC; we are both lawyers as well, so you should understand that I am not purporting to speak as an accountant here. All I can say is that, as a matter of fact, that is true because, in effect, it says that if there were no reporting obligations under the Corporations Act there would be no reporting obligations under the Corporations Act. That is a slightly different question. It is theoretical at the moment because we have not seen in this country, and we usually do not see it elsewhere, any private equity transaction that has been run entirely through a trust. My advice to anybody who is contemplating doing that would be to see a lawyer at an early stage and understand that liabilities for trustees and liabilities through a limited liability regime are quite different. It is theoretically true. How practically possible it would be to do a transaction in that way I think is a little more open to question.

Senator FIELDING—I appreciate the response, too. The reason I raised it was that obviously they are a government body and their last paragraph says that there may be a case for the committee considering whether changes might be made to the law in that area.

Mr Rodgers—That would be the law about the public reporting responsibilities of trustees.

Senator FIELDING—I understand that you are part of the Council of Financial Regulators, along with the RBA?

Mr Rodgers—Yes.

Senator FIELDING—What discussions have you had around that table about the issue of sizeable amounts of tax revenue that would be lost to Australia in these private equity dealings? You are part of that group, so I ask you this publicly: what discussions have you had?

Mr Rodgers—I can answer that. I am a member of the Council of Financial Regulators. The short answer is: very little. Around that table sit representatives from the Reserve Bank, APRA, ASIC and Treasury. It is effectively a council of financial regulators. In the work that we did that led up to the publication in the financial stability report—because we each contributed from our own perspective—while we understood that there were potentially, if I can put it that way, taxation implications from increases in private equity, it is not the job of that body to deal with that issue, and we chose not to go into that.

Senator JOYCE—Very wise!

Mr Rodgers—Effectively there were three perspectives. There was the systemic stability perspective, which is the job of the Reserve Bank; the prudential perspective, which is the job of APRA; and the market and conduct regulation perspective, which is ASIC's perspective. They, by and large, are the perspectives reflected in the work of the Council of Financial Regulators.

Senator FIELDING—I fully understand that. The reason I asked is that you are part of the same body as the Reserve Bank and a few others, and the Reserve Bank made the statement:

> The implications for Government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity on tax revenue.

I was asking if that was in some of the discussions you have had. The answer is obviously no.

Mr Rodgers—It was something that we did not discuss. I think, as you heard from the earlier witness, that that is simply a statement of fact and does not, I think, reflect deep deliberation by the council on taxation implications.

Senator FIELDING—You may be aware that in the US two bills were introduced in June arguing that the benefits of private equity deals are generally only available to institutions and wealthy people and that private equity deals should be properly taxed. They say that private equity takeovers should not be structured in a way to avoid paying tax when the essential service from a takeover group is an asset management service and companies that pay normal tax provide much the same service. Would you like to comment on any of that? What is your view on that sort of view from America?

Mr Cooper—It is very difficult to translate from one regulatory and tax regime over to here, and I am afraid that is—

Senator FIELDING—Are you aware of them?

Mr Cooper—No.

Senator FIELDING—You are not aware of these recent moves on private equity, which is—

Mr Cooper—I think we should not for a minute pretend any expertise in tax policy.

Senator FIELDING—There are huge concerns over there with private equity at the moment, and I thought that maybe you were looking at that. I thought, when we talked about the International Accounting Standards Board—you mentioned that before—and the international accounting area, that that would have been relevant.

Mr Rodgers—We do have responsibilities for monitoring companies' compliance with accounting standards, so that is an area that, not necessarily at this table but organisationally, we would claim some expertise in.

CHAIR—With the leave of my colleagues, I will have the luxury of the last minute. I have a couple of very quick questions that I jotted down during your evidence. The potential for conflict occurs in a very broad suite of companies, doesn't it? Indeed, looking at the plethora of CLERP legislation would make it very clear that this is an issue in that full suite of companies, not just in PE based companies.

Mr Cooper—Correct. We agree with that, and we think there is a lot of evidence that the Australian market is acutely aware of conflict issues and so, when they occur in the system, participants are very quick to spot them.

Mr Rodgers—What we said in the Council of Financial Regulators is that there is a particular way in which these transactions are done, and that produces, potentially—you will see things arise in that kind of transaction and in a way that you would not in others, but that is true of any major transaction type. That is not confined to private equity.

CHAIR—Basically, most of this discussion, certainly in the last six months, has been in relation to the LBO situation. Just so that we can clarify this: I presume the rules under the Corporations Act relate as much to the bidding vehicle as they do to the takeover target in relation to these particular issues—again with that full suite of responsibilities under the Corporations Act.

Mr Rodgers—That is correct. In some senses it is slightly narrower than the LBOs, because these are—most of the debate is about public to private transactions. Certainly all of the conduct associated with the takeover of a publicly listed company is fully regulated—what the bidder does, what the target does, what the advisers do is subject to a reasonably comprehensive regulatory regime.

Mr Cooper—Quite. Qantas is the perfect example of that: talked about in loose terms as a private equity transaction but, in actual fact, structurally, the mechanics of it were a perfectly straightforward takeover bid by a company for a company, both of which were fully regulated.

CHAIR—I take it that any discussion about the powers under the Corporations Act would be about the extent of the implementation of those rules as opposed to the integrity of the rules themselves to deal with these types of situations.

Mr Cooper—Yes, we agree with that.

CHAIR—Does the council intend to continue monitoring the private equity situation?

Mr Rodgers—In the financial stability report, each of the individual members of the council, having contributed their thinking on the issues that increased private equity activity might mean for them, committed individually to continuing to monitor. As the witness from the Reserve Bank said this morning, if there were issues that we had not put our minds to, if they arose and they potentially involved more than one of the perspectives that I have talked about, then you could expect further discussion of the council.

CHAIR—So, if there were some individual concern, that would become a collective responsibility through the council?

Mr Rodgers—If it were a concern that might affect more than just ASIC. For example, if it were a concern that affected both the Reserve Bank's remit and APRA's remit, you might expect further discussion of the council.

CHAIR—Thank you very much. We have gone a bit over time and I apologise for that.

[11.49 am]

KARP, Mr Tom, Executive General Manager, Supervisory Support Division, Australian Prudential Regulation Authority

CHAIR—Welcome. You have been around long enough to know what the normal chair's cautions are in relation to these matters. Do you wish to make an opening statement?

Mr Karp—I am pleased to appear here today to talk about private equity from APRA's perspective. Firstly, as you have already heard, there are a number of issues to consider in relation to the growth in private equity. Many of those have been considered by the Council of Financial Regulators, which includes APRA. Mr Battellino has covered a number of these, especially the systemic risk issues, so I would like to focus on APRA's view of the impacts of private equity on prudential issues.

The prudential issues essentially amount to what the exposures of APRA-regulated entities to private equity are and how these exposures are managed. In practice, this means banks' exposures via lending, and superannuation funds' exposures via equity investments and marketed debt instruments.

Given the primary role of debt financing, it is not surprising that banks are an integral part of private equity structures. It is difficult to measure banks' exposures to private equity at any given point in time because the transactions are large and infrequent and are heavily influenced by transitory underwriting exposures. But, based on the confidential information reported to APRA, as of 31 December 2006 the gross private equity exposures of Australian banks totalled approximately $A15 billion. Foreign banks operating in Australia reported an additional $20 billion in local exposures, although not all of this amount is actually booked to the local Australian branch. In Australia more than half of these exposures consist of short-term underwriting commitments by the banks.

Because about half of these reported exposures relate to initial commitments of banks to underwrite and participate in new private equity deals, there is a substantial double counting of the same exposures across institutions. So, on a net basis, it is likely that the overall exposure is much closer to the total amount of outstanding private equity debt of around $23 billion and, in any case, less than 10 per cent of banks' total on-balance-sheet loans to non-financial corporations of about $330 billion at the end of December.

The banks' exposures reported to APRA are concentrated in the five largest domestic banks. These banks have active diversified portfolios of these types of leveraged exposures. The banks that have been involved in underwriting new debt generally hold no more than about 10 per cent or around $50 million to $100 million for individual large deals, because other banks participate in syndications. The banks also operate with overall portfolio limits on the aggregate of their private equity and leveraged lending exposures, and in the large banks these limits are generally in the range of $1 billion to $3 billion, which is less than five to 10 per cent of the total capital for a bank.

Most of the private equity exposures consist of senior secured debt holdings, and a substantial proportion of those exposures remain undrawn. Some of the foreign banks permit subordinated lending if the bank is also involved in the senior debt issuance and provided the subordinated exposures are limited to around 10 to 15 per cent of the overall debt of the company.

Generally banks have policies for their leveraged lending, and this encompasses private equity lending. So the banks are closely attuned to the risks in the private equity transactions and they all involve formal credit approvals and ongoing monitoring. So essentially all of these transactions are identified in the banks as leveraged lending and thus higher risk. They have higher pricing on the loans to reflect that higher risk, there is often independent risk review of the lending and there are commonly structuring requirements such as collateral, covenants and then formal monitoring and reporting requirements and, as I mentioned earlier, portfolio limits on their total exposures.

Given that the private equity exposures of the Australian banks are concentrated in the lower risk senior debt and that it appears relatively small in relation to their capital and overall lending portfolios and because if anything the Australian banks appear to be taking a fairly cautious approach in comparison to some of their international peers and because APRA continue to review the capital allocation risk management as part of our regular supervision program, we do not see any significant prudential risks in private equity to the banks.

Turning to superannuation for a moment, in the last few years there has been a clearly observable trend, with super funds moving to alternative investments, and that includes private equity. It is very difficult to get a precise handle on the amount of that, because the regularly collected data does not separately identify private equity. But, as best as we can determine, the private equity exposure of the Australian super funds which are regulated by APRA is around one per cent of total assets. That is our estimate. Individual funds have varying private equity exposures, with an on average exposure of around five per cent of the fund. Some would have zero; some may have up to 10 per cent or even a little bit higher. The prudential risks there arise essentially from the greater risk in the private equity investment, albeit that over the long run the expected return is likely to be higher. There is also a potential impact on super fund liquidity, given that a lot of private equity investment is not highly liquid. This comes at the same time as when the portability rules mean that super funds may be called upon to meet more redemptions than in the past.

Turning very quickly to the regulatory arrangements, there are no statutory or prudential limits on super fund investments in private equity or for that matter in any other asset class. But the super fund trustees are responsible for managing these risks in making their investment decisions. In 2006, after extensive consultation with the industry and government, APRA issued a circular that sets out expectations with respect to investment management decisions, and with respect to private equity APRA noted that:

Non-traditional assets, such as infrastructure, private equity and public-private partnerships, are acceptable in a diversified portfolio, provided the trustee has considered their expected return and diversification effect on the portfolio and can demonstrate appropriate expertise and process to manage such asset classes within a superannuation fund portfolio.

Further, in APRA on-site reviews of super funds, one of our key objectives is to determine the trustees' understanding of their investment strategy, particularly in the case of alternative asset

classes. Our supervisors assess how this has been managed and in particular how the asset consultant who is advising the trustee is assessed, how the independent valuation process for such alternative investments is carried out and how any due diligence processes are conducted with large transactions.

Given the limited exposure of super funds to private equity and the lack of concerns from our on-site reviews, APRA currently have no significant prudential concerns about private equity investments by super funds. But, while that remains our view in respect of both the banks and the super funds at the moment, it is an issue that we believe needs continual monitoring and we will be looking at it as part of our normal supervision. To the extent that our view changes or the situation changes, we will be bringing that to discussions with the council's financial regulators so that all of the other members are aware.

CHAIR—What is the nature and extent of those on-site visits to the super funds?

Mr Karp—The frequency of our visits to individual institutions, whether they be banks or super funds, varies somewhat depending on our view of the institution. We have a process of assessing the variety of risk within an institution and how bad or good we think it is, and that drives our supervision process. At the moment, after licensing of superannuation funds, the number of funds has come down significantly. We now expect that we would be doing an on-site review of super funds about every two to three years as a maximum. Some funds will be visited far more frequently than that. But, for those we regard as being quite well run and with which we have no particular points for concern, we would still go back within the two- to three-year period.

CHAIR—What situation or situations do you envisage would lead you to go back to the council in relation to this issue?

Mr Karp—In respect of superannuation in particular—I presume that is what you are asking—if the boom, as it has been, in private equity investment continues rather than abates, as is more likely, and the super fund exposures start to become a lot more than one per cent of total assets or a lot more than 10 per cent in any individual fund, we would start alerting other members to that and be looking more closely ourselves. Secondly, if we were starting to find from on-site reviews, and we have not found this to date, that the management of these private equity investments by the super funds was not being done in what I would call a highly professional and disciplined way—that is, we were starting to see some laxity in that—then we would also be raising that as a concern, as well as taking the action that we can take as an individual supervisor.

CHAIR——Are you confident there was appropriate adherence by the super funds industry to the practice direction, effectively, that you sent out last year?

Mr Karp—Yes, we are. But, by the same token, it has to be recognised that that investment circular and the statements in it are essentially statements of principle that we are expecting the trustees of super funds to follow as they go about their investment processes. As we do our on-site reviews and assessments of funds, we clearly need to look at how that is being carried out by individual funds. At the moment, we have no reason to believe that those statements of principle are not being followed.

CHAIR—Finally, are you confident that your monitoring processes would identify early on any potential trend which might require a visit report back to the council?

Mr Karp—We do get regular returns from funds. We do get annual returns from all funds, but any super fund which has more than $50 million we get quarterly returns from. So that gives us the ability to identify relatively early any major change in asset mix or growth in assets of the funds, and we could then act on that to go and do another review if we felt things had been changing dramatically. Obviously, we are out there in the market regularly. We have contact with a number of the funds. We have contact with a number of the professional advisers, asset consultants and the like. So we do pick up signals of unusual practices by funds that might be starting to emerge. All of those things go into our intelligence, if you like, for us to determine when we would next go and visit a fund.

Senator STEPHENS—Mr Karp, when you were talking about banks and the arrangements for senior secured debt holdings, you indicated that there were some portfolio limits of around five per cent. Then you said—I am just trying to understand the point that you made—that there was some subordinated debt.

Mr Karp—There is subordinated debt in many of the issues—

Senator STEPHENS—Is that an additional 10 to 15 per cent or is it part of that overall?

Mr Karp—My point there was that many of the debt issues associated with private equity investments do have tranches of debt. The banks mostly have only holdings in the senior debt. They usually have very little holdings in the subordinated debt. The foreign banks which operate in Australia are a slight exception. They will often take a part of that subordinated debt, but normally only a fraction of it. Quite often that exposure will be shipped back overseas to the parent rather than kept on the Australian books. So there is some exposure of the banks to subordinated debt but a lot of that subordinated debt, as you have heard from previous witnesses, is collaterised or securitised and sold off.

Senator STEPHENS—You made that point when you started your opening statement about some of that foreign-held debt representing short-term underwriting commitments. What is ‘short-term’ in this regard?

Mr Karp—In many cases for these arrangements short-term would be 90 days. Quite often, as well as providing debt funding, the banks will be involved in subunderwriting. So if the private equity buyer is out there raising capital as well, the bank will have some exposure if that raising does not come off, and they may have to hold equities eventually. It is usually that component which is underwritten, and they may also be underwriting some of the debt. So it is a short-term exposure until the rest of the market picks up.

Senator STEPHENS—In terms of the use of covenant light lending that we have been hearing so much about, does APRA have any concerns about that from a prudential perspective, particularly using instruments such as toggle notes to make interest payments on a new debt?

Mr Karp—Generally, we are concerned to see that the risk assessment that the bank is making about their exposure is adequate and to the extent that they are lightening the covenants

that they might otherwise have—that is, a lightening of their credit conditions. So that is of concern to us. But, given that the overall exposures that we are talking about here are small in the overall scheme of things and because a lot of these are special and one-off deals and often extra formal reporting and monitoring requirements are put into the structure of the debt issue, we think on balance that it is not a major problem at the moment. If the boom were to continue and covenant light provisions were to become more common, then we would be more concerned about it.

Senator STEPHENS—Does APRA have any concerns about the fact that insurance companies are significant investors in private equity funds?

Mr Karp—Most of that is insurance companies via superannuation because most of the insurance company investment is the life companies and it usually is the superannuation money. So our concerns there are the same as we have for superannuation funds per se because it is superannuation money that the life companies are mostly investing into these sorts of structures. But there are no greater concerns there than there are in superannuation generally.

Senator STEPHENS—So you do not rate investments in private equity funds differently to other assets held by insurance companies?

Mr Karp—We do not rate any investments per se. We look at the investments that are being made on a sort of asset class basis rather than as individual investments. We have views about different types of investments, and we are concerned to see that the diversification policy that trustees have set down is being adhered to and followed and that they are getting proper professional advice, as a good institutional investor would. It is not our role to second-guess these people as to what the money goes into. At the end of the day, the trustees have a fiduciary obligation to invest on behalf of members and take those risks into account in making those decisions.

CHAIR—I should have probably mentioned something earlier—that is, to pass on the apologies of Senator Murray. I should have done that at the start of this hearing. I now do that, given that he was fairly actively involved in this inquiry. He is not well and he passes his apologies on. I apologise to Senator Murray for not doing this earlier.

Senator JOYCE—I endorse your views. He was vital in bringing this inquiry about. Mr Karp, I am going to ask you a question, just to set a framework, because I can hear two schools of thought. Why do we need to regulate prudential authorities?

Mr Karp—To go back to the Wallis inquiry, which led to the setting up of APRA and the current financial regulatory framework that we have in Australia, essentially we have a prudential regulator because there are certain types of financial institutions that people are either investing or placing their money with, and the government has come to the view that it is hard for individuals who are doing that to make the right judgements about the safety of that institution. So you create a prudential regulator to try to step in the shoes of that person and make that judgement about the safety of institutions.

Senator JOYCE—That is very important. It is obviously in the national interest that we have a prudential regulator. It is to assist in the transparency in perceiving what the individual investor or the individual participant in prudential authorities cannot see.

Mr Karp—It is to assist individuals who are not otherwise able to make that proper risk assessment themselves. But one thing needs to be clearly remembered and that is that, coming out of the Wallis inquiry, the defining line between which financial products or financial institutions should be prudentially regulated and which should not be was made. So we have banks, insurance companies and superannuation being prudentially regulated but we do not have managed funds, which are not superannuation, being—

Senator JOYCE—But, basically, it is a statement that if you just relied on the market, the good banks would go broke and other banks would survive and, unfortunately, the ones that went broke would cause an absolute swathe of discomfort, hurt and dislocation through the economy which would not be accepted.

Mr Karp—I think some of it comes back to Mr Battellino's comments of this morning. We have an open market in the economy, and we are relying on the market to a reasonable degree. If you regulate so tightly as to not allow some investors to take some risk in the market, eventually the economy will not be getting the productivity and the investment returns it needs.

Senator JOYCE—I am moving to the next question because there is the belief that this is just another form of corporate investing. I went next door for a cup of coffee this morning to a small retail outlet. I should have asked them if there have been any inquiries from any private equity firms to invest in that coffee shop; I imagine that they would have said, 'No'. I have a little wheat place and no-one has approached me lately; I wish they would. So there is inherently an area where private equity firms are investing. You could basically categorise it as a large section of the market. It is not just like investment in your local corner store or a caveat light investment in a house. It is a specific market that they are targeting.

Mr Karp—Sorry, is that the private equity buyer?

Senator JOYCE—The question is: there is nothing generic between the investment by others in that corner store and the investment by private equity firms in Coles? They are going to concentrate on Coles. They are not going to concentrate on Mrs Crockett's corner store.

Mr Karp—Yes, because the whole rationale behind it is that they believe that they have identified something which is not being run as well as it could be or as efficiently as it could be and that they can do it better.

CHAIR—Which is no reflection on Mrs Crockett.

Mr Karp—Yes, of course.

Senator JOYCE—So calling to mind that they are going to the top of the market and a larger section of the market, they have a magnified effect on the market if something goes wrong.

Mr Karp—To the extent that they are involved in larger investments and they go wrong, then potentially, yes, that could have a larger impact on the market.

Senator JOYCE—And the crux of their success is basically that their rate of interest is below the rate of return, so in the longer time frame they will prevail. But there are variant factors out there, because inherently their debt rating says obviously—I will cut that. Do you believe—

CHAIR—Senator Joyce, can you put some of this commentary by way of questions?

Senator JOYCE—Okay. Do you believe that, if you have high debt, you have higher risk?

Mr Karp—Yes.

Senator JOYCE—How do we ascertain the risk of private equity firms when we cannot get the transparency that is required to ascertain that?

Mr Karp—It is probably more an ASIC type area of comment, but what I will say is that—as I think some of the other witnesses have said—a lot of the investment, at least via debt, that goes into these structures is actually packaged up and sold in the marketplace. So there is actually public exposure and information that has to be made available when those debt structures are actually offered.

Senator JOYCE—In controlling their investment—and having had a brief experience in banking myself of about five years, to control my investment I am going to load it with caveats to protect it. That would be a fair statement, wouldn't it? The more extensive my investment, the more extensive will be my caveats to control it.

Mr Karp—Yes, that is the general way that banks would operate.

Senator JOYCE—So do you believe that in essence I can go to a point where I have evolved from a debt position to an equity position, in that I have predetermined KPIs that you must hit and if you do not hit those KPIs I will either withdraw my funds or increase your interest rate?

Mr Karp—Those are some of the sorts of things that would be included in the structures, and there is always the potential for some of the lending of the banks to go bad and for them to potentially become an equity holder.

Senator JOYCE—Therefore, in essence, we have to ask the question: when does debt become equity?

Mr Karp—I think the relevant question is—

CHAIR—Is this a matter for APRA?

Mr Karp—The relevant question is: when does the debt become a non-performing debt, because that is when it is a cost to the bank in terms of capital.

Senator JOYCE—If I buy and sell and buy and sell and buy and sell a company, am I engaged in the investment in capital assets or is there a time where it becomes income?

Mr Karp—It sounds to me like that is more a tax question than a prudential question.

Senator JOYCE—Do you think we need a code of conduct to get greater transparency, or is APRA happy with the tools that are currently at its disposal?

Mr Karp—APRA is happy with the regulatory arrangements at the moment. We, as you have heard, are a member of the Council of Financial Regulators. This particular issue of transparency is more one for ASIC, but, from our understanding of it and from what we have learnt from ASIC, we are happy with the situation as it is.

Senator JOYCE—What should super funds disclose about their involvement in private equity firms?

Mr Karp—Super funds do not have to disclose their specific investments in private equity firms, like they do not have to disclose their specific investments in any other particular asset class or asset. They do have to disclose their asset mix and their return on assets into broad asset classes. So, to the extent that they are heavily involved in private equity, that will come out through that particular disclosure.

Senator JOYCE—Obviously a big part of your job is to demand of people that they display the risk. How is someone going to assess the risk in a private equity firm when you do not have the mechanisms—for instance, we can go right to the disclosure of directors' fees. You are not going to see that, are you, in a private equity firm? That is probably one of the reasons why certain people are so keen on them.

Mr Karp—If a super fund is achieving a very small exposure to private equity, it is probably doing that through some other vehicle, some other managed fund that has downstream private equity investments. So they would not then be seeing the downstream details. But, if a super fund is taking a larger exposure and a sizable part of an individual transaction, then they would—and we would expect them to—get professional advice from investment advisers in the market and asset consultants. Those people will be talking with the private equity sponsors and raisers of capital and saying, 'Unless we get this information, we're not going to be putting our money in.'

Senator JOYCE—But things can change. As you know, they might want to come back later on. Do they have any legal mechanism of requiring that information, or is all they can do ask and then hope?

Mr Karp—They can definitely ask up-front and, if they do not get the information, then they will not invest. But on an ongoing basis, if they are a substantial investor in that private equity arrangement, they are part of that private equity operation. While there might not be a lot of public information available, they would be asking and expecting to get regular information about the operation of that private equity arrangement.

Senator JOYCE—They are part of that operation; they are therefore part of that risk. Turning to the disclosure of directors' conflicts of interest, obviously, it is inevitably extremely important that at the front end of any private equity deal we have a clear and unbiased position of stewardship from the directors. Do you believe that under our current regulatory environment that degree of stewardship is being maintained? Or could it be held in question as to whether the degree of stewardship that is desired by the shareholder is available to them, especially in management lockouts?

CHAIR—Senator, the only problem with that question is that I think you are asking Mr Karp to proffer an opinion on behalf of a shareholder, whether it be a super fund or something else, which I do not think is reasonable. Perhaps you might like to rephrase it.

Senator JOYCE—I will be more specific. What regulatory mechanisms do you have to deal with management lockouts so as to provide the shareholder with their right of stewardship over their asset so that in the long term we do not sell, for instance, an airline company for a price which, in the very short-term, would be worth a lot more than that in any case?

Mr Karp—The regulatory requirements, if you like, are mostly in the ASIC arena. They are mostly Corporations Law requirements on directors and others to properly manage conflicts of interest. The only extra—if I can put it that way—regulatory layer which comes into play from the APRA perspective is that trustees of the super funds are under an obligation to be diligent about how they make investment decisions on behalf of members. That requires them to dig as much as they can into new and unusual transactions and satisfy themselves that they are getting value for money.

Senator JOYCE—What tools do they use with private equity firms to dig down?

Mr Karp—I keep coming back to the point that, ultimately, if the private equity firms need to get money and some of that money needs to come from super funds, they will only get it if they provide the super funds with enough information for them to make the decision to invest.

Senator JOYCE—Goodwill.

Senator BERNARDI—There has been a lot of talk about the risk attached to private equity and the risk to superannuation funds and a whole range of areas. Are you aware of any significant businesses that are regulated by APRA that have collapsed and caused some pain to the Australian economy?

Mr Karp—HIH clearly caused some pain to the Australian economy.

Senator BERNARDI—So there is, even in a listed company, the risk of collapse due to management issues and lack of prudential operation.

Mr Karp—Yes, there is. While as a prudential regulator we are clearly charged with the responsibility to regulate the institutions that we have to keep the system safe, we cannot do that with a zero rate of failure. There always must be some small risk of failure of the institutions we regulate; albeit that it is very small, it still exists.

Senator BERNARDI—I am not having a go at APRA at all. I just want to establish that private equity deals and unlisted company structures are not inherently more risky than any other investment structure from a national interest basis, as Senator Joyce continues to refer to.

Mr Karp—My comment there is that the level of risk in private equity is essentially determined by the level of gearing in the operation. To the extent that the gearing in private equity deals is higher than the gearing generally there will be higher risk. But that higher risk would also apply to other structures where there is higher gearing.

Senator BERNARDI—Absolutely, so it comes down to the ability of management to determine what is an appropriate level of risk and an appropriate level of gearing, and that is applicable across every industry and every structure, isn't it?

Mr Karp—Yes, I think that is right.

Senator BERNARDI—You also mentioned the superannuation funds and how there is an obligation on trustees—a fiduciary obligation—to act in the best interests of the fund holders. They can determine where they would like to invest assets as long as it is in accordance with their offering document or a statement to the public about where they are going to invest and under what broad parameters. Is that fair enough to say?

Mr Karp—Yes. Those superannuation funds which are public offer superannuation funds normally have product disclosure type documents which convey the type of asset mix that investors will get if they invest in the fund. So they are obliged to operate within those parameters and achieve that asset mix.

Senator BERNARDI—So if there was a public offer superannuation fund that said, 'Yes, we're going to put 25 per cent of our assets into private equity vehicles or private equity deals,' that in itself is not cause for alarm as long as it is disclosed through the offer document. Is that right?

Mr Karp—That is the principle on which our system of regulation is based, yes.

Senator BERNARDI—You also said that returns are higher in private equity transactions over the longer term.

Mr Karp—I said that they were expected to be.

Senator BERNARDI—That takes into account, obviously, any failure of funds like a catastrophic failure of an investment or an inability to redeem an investment, I presume, over the course of time.

Mr Karp—But this is no different from the normal risk return trade-off for any investments. Superannuation funds have a large component of their funds invested in equities, and the reason they do that is that they expect over the long run they will get a higher return than if they invest purely in fixed interest investments. So this is just an extension of that.

Senator BERNARDI—Just another asset class. It comes down then to the question of audit and compliance. With a large superannuation fund there is an audit process that goes through. Does that take place six monthly or simply annually for their reports?

Mr Karp—Audits are only done annually. The returns to us about their financial information are done annually for all funds but quarterly for large funds above $50 million.

Senator BERNARDI—Does the auditor have to be a registered company auditor?

Mr Karp—Yes.

Senator BERNARDI—Is there a different audit requirement for self-managed super funds?

Mr Karp—There is. Off the top of my head I cannot tell you precisely what the requirements are because the self-managed super funds are regulated or administered by the Taxation Office, not by APRA.

Senator BERNARDI—If there is a different level of audit, that might expose a risk to a self-managed super fund that may not be compliant with their investment mandate.

Mr Karp—That is possible. The only comment I can make is that the rationale behind having self-managed super funds regulated by the Taxation Office rather than APRA is that the self-managed super fund has five members or less, all of whom must be trustees. The principle is that they are all trustees and they all know what they are investing in, so who are you protecting them from by giving them an extra layer of prudential regulation?

Senator BERNARDI—You do not think that we need to protect people from themselves?

Mr Karp—When they are investing their own money—

Senator BERNARDI—So if they are investing their own money it is okay, they can choose where they put it. I applaud that sentiment.

Mr Karp—That is the rationale behind the regulatory structure.

CHAIR—Questions, Senator Bernardi, not statements!

Senator BERNARDI—Thank you. I have no further questions.

Senator WEBBER—Given that the two most significant economic decisions most people make are their investments in their own home and their superannuation fund, if superannuation funds become more exposed to private equity investments—and you were having a conversation with Senator Joyce earlier about how much or how little those funds have to disclose their exposure—what impact will that have on Australia's retirement income policy?

Mr Karp—As I said earlier, the issue of investing in private equity, because it is more risky due to its leverage, is an issue that applies to all asset classes that superannuation funds invest in. If we look at the overall asset mix of super funds, we see that in the order of 50 per cent of the

assets of super funds are invested in equities generally and not private equity. So there always is, and there already is, that sort of risk-return trade-off. The issue here is that, if super funds' exposure to private equity continues to grow and becomes what I would call a major asset class rather than the minor exposure that it is now, then the likely thing that APRA would do is to say that that has to be separately identified in annual reports to members so that people are aware of it. We would be tracking the returns on it and people would be aware of that. Ultimately, the issue rests with the individual trustees of the fund to make investment strategies that give them an appropriate diversity of investments to match the expectations and the demographic profile of the members of that fund.

Superannuation funds are long-term investors because these are normally long-term savings. Therefore, they are a vehicle that is better able to invest in structures that might be a bit more risky and more volatile in the short run but may provide a higher return in the long run. In the long run, one of the biggest risks for Australians in their retirement is that they might have had very safe investments in their super and not lost any money, but they might have lost one to two per cent of extra return over 20 to 30 years, and that can make a lot of difference to their end retirement. It is a question of getting the balance right between the extra return that you expect to get and the extra risk that you are taking on.

Senator WEBBER—Are they necessarily going to remain long-term investors given the new portability arrangements?

Mr Karp—The new portability arrangements will place an extra responsibility on the trustees to look more closely at the liquidity needs of the fund. So it is fair comment to make that the investment horizon that they have had traditionally might have to be shortened a little because of that. That does not mean that a trustee would be determining an investment which is assuming that 50 or 80 per cent of the fund is going to need to be liquidated in a very short space of time. We would expect them to look at the inflows and outflows of their funds—and some of them do—to project their liquidity needs and match their investment strategy accordingly. That would still mean that a substantial part of their asset base could be invested long term.

Senator WEBBER—There was a brief discussion before about whether there really was a need for increased regulation and there seemed to be a consensus view, within the commentary at least. I would like to come at it another way: do we have sufficient regulation and do we resource the regulators properly to ensure that we do not have increased risk on things like our retirement income policy?

Mr Karp—On the question of resourcing the regulator, you will see from our annual reports over the last three to four years that APRA resources have been increased quite significantly. We are now in a position where we believe we have adequate resources to do the job. I have to say that this is a piece of string. You can always use more resources. There are always more things you can do, but we do not have a view at the moment that we are underresourced in any shape or form.

Senator STEPHENS—One thing I want to talk to you about is the issue of fees that have been paid in relation to private equity investment deals that are going on. I think the discovery of the level of fees that were being paid in regard to the Coles arrangements was quite disquieting. The issue that we have had raised before us in some of the documentation is the very tight

arrangements that now exist between private equity arrangements, hedge funds and transaction based investment banks and how they can lead to quite extraordinary fees being paid and transferred across those entities. Is that an issue of concern to APRA in relation to fees being paid either by banks or by the super funds?

Mr Karp—APRA does not have a particular concern about the level of those fees. Our view is generally that the marketplace is there to determine the level of those fees, as long as those fees are known and available to the end investors, because ultimately whatever fees are taken out for advisers and everyone else will come out of the return on what the end investors put in. As long as end investors are aware of that and are able to make judgements for themselves about the value of those fees then we do not have a particular concern about them.

Senator STEPHENS—What about the other issue raised by those tight arrangements requiring companies to provide information that the shareholders do not have as part of due diligence arrangements? Is that a concern to APRA?

Mr Karp—No, it is not, but again this is more ASIC territory in terms of takeover requirements and the like. This is, I have to say, normal practice around the world for these sorts of things. They are complex arrangements. People are investing large amounts of money. They want to drill into an operation and that requires them often to assess an operation in far more depth than is available in the public domain. That is why the confidential rooms are set up with all the information. We do not have any concerns about that process, but it is more an ASIC area of responsibility.

Senator STEPHENS—Thank you.

CHAIR—Thank you, Mr Karp. I should say, for those who might be interested, that the information provided by the RBA this morning is on the committee’s website, and, for those who are present, I gather that there is some further information from the RBA. It is the original report: the *Financial Stability Review*. That is the excerpt we were referring to this morning. It is available.

Proceedings suspended from 12.41 pm to 1.45 pm

EVANS, Mr Ralph, Chief Executive Officer, Australian Institute of Company Directors

UPTON, Ms Gabrielle, Legal Counsel, Australian Institute of Company Directors

CHAIR—I welcome representatives from the Australian Institute of Company Directors. Mr Evans, have you appeared before committees before and are you aware of the normal cautions and information associated with the conduct of these hearings?

Mr Evans—Yes, I have.

CHAIR—Would you like to make an opening statement?

Mr Evans—Yes, thank you. Let me say first of all that I think one of the strengths of our democracy is that people like us do have opportunities to speak directly to their parliamentary representatives and that is a very good thing. A message first of all for the directors of Australia about private equity is to be ready to make sure you know what to do in the event of an approach. The private equity wave has increased the need for rigour and discipline and has put some people under great stress. In this situation, the board of a company must show leadership. It is appropriate that they be well prepared and know what to do. We produced a guide for directors in a situation of change of control and it is quite similar in its contents to a guide produced by the Takeovers Panel. It is slightly differently expressed but it says much the same sorts of things.

CHAIR—I am sorry to interrupt but I see you have some documentation. Was it your intention to distribute that?

Mr Evans—I seek leave to tender the documents.

CHAIR—Please do so.

Mr Evans—There are a number of documents there, including this guide. The main principle in it is that directors must act in the best interests of the company and its shareholders. As well, it is incumbent for them, in preparing for the possible arrival of a private equity offer, to consider what the private equity people might do with the business—for instance, some restructuring. If it is to add value to the company, to the enterprise, then they should consider actually doing it in anticipation of a private equity offer.

A message to the parliament is a different one, which is that more regulation is not needed in this field. There is a robust framework in place with the Corporations Act, the Takeovers Panel, the activities of ASIC and so forth. Some would see the private equity surge that has occurred partly as a reaction to over-regulation of the public limited company, where the directors spend more time than they would like on compliance and less than they would like on adding value to the enterprise. Perhaps the emphasis should be on achieving a better balance between compliance and adding value to enterprises.

We would expect to see private equity take its place alongside public company mergers and acquisitions as a normal device for the restructuring of companies. It is in the interests of efficient capital markets, of the value of retirement savings and of the economy as a whole. The recent surge has been due to very exceptional circumstances and cannot be extrapolated into the stratosphere. In fact, there are signs that it is receding already. Private equity is relevant for small companies that outgrow founder managers and for divestitures of divisions of big companies as well as for the takeover and restructuring of whole large companies, which has attracted so much attention in the press of late. So we believe it will have a place in the community in the future. That concludes my opening statement. I am happy to answer any questions.

Senator STEPHENS—Mr Evans, you made the comment that the compliance burden could be one reason for moving to private equity structures. Can you give us any indication of more than anecdotal evidence that that is the case? What evidence is there that that might be a major force?

Mr Evans—Let me add a bit of weight to the anecdotal evidence with personal experience because I have been a director of a management buyout. It was quite a few years ago; it was Orlando Wines and I think it was fairly typical of its kind. It seemed big at the time. It was much smaller than some happening at the moment. The directors representing the shareholders were around the table regularly. One hundred per cent of the shareholders of the business were directly represented there. The directors were not people at a distance representing shareholders whom they did not actually know or with whom they had no contact. They did not have to report to anybody except the bank. There was no continuous disclosure to the stock market of any development that might affect the value of the company, for instance, so they focused on the reports that are necessary to the lenders and made sure the debt was repaid according to its schedule. There was big trouble if there were any questions about that but the rest of their attention was focused entirely on the future value of the business at some distance out. In that case, it was about 2½ years; that is shorter than usual. Usually it is three to five years out when you would expect there to be a liquidity event—that is, a sale or relisting of the company. All the focus was on adding the value once we were sure that it was safely going to be repaid.

Senator STEPHENS—You were not here this morning, but we had a discussion with some of the regulatory witnesses. The Reserve Bank and ASIC were quite clear that they did not believe that there were compliance burdens and ASIC and APRA were quite adamant that they did not believe that it was having the effect of actually moving people into the private equity stream because of the compliance issues. We had a significant public company director in Don Argus who made those comments about the compliance issues in recent months. He also made the important point about the reluctance of people to take up public company directorships because of the compliance burden and the exposure that they face as directors in that situation. Is that something that your membership is concerned about?

Mr Evans—Yes, it is. Let me say there are still plenty of people offering to be company directors but some of the best ones, whom you would really like to have as directors, are saying, ‘It’s not attractive.’ I do not want to name one who is specifically in my mind, but somebody I know quite well is soon to leave all his public companies and a major private one because he finds it not much fun anymore. In particular, the problem is that he is monitoring things, in this case a financial entity, on behalf of APRA, when what he would really like to be doing is building the business, but he spends far too much time on compliance. So, yes, I cannot say I

have a large numerical sample or anything of the kind but, certainly, plenty of people, particularly from the high end, some of the more experienced directors, tell us they do not like it very much because of this balance.

Senator STEPHENS—We have had some evidence through the submissions that private equity acts as a discipline for public companies. Is that your experience?

Mr Evans—I think that is probably right. By analogy, it is a bit like the discipline that the predators in the jungle might apply. If a company falls behind too much to below its potential value, there are public listed companies that might acquire it and eat it up, but there are also private people who are always looking for opportunities where they can transform a company and add value to it. There is a discipline. If you do not want to be chewed up and consumed by this process, you have to stay well ahead of it.

Senator STEPHENS—You say in your submission that insider participation in corporate control of transactions is more likely when private equity is available as a vehicle. Why do you say that?

Mr Evans—This is the source of much of what our guide and also the guide that came from the Takeovers Panel was all about, that these sorts of approaches can quite often come from financial bodies to executives of the company or, in fact, be dreamed up by the executives themselves who might go to a potential financier. So you get the initiative sometimes coming from within the company at a senior level—officers of the company, sometimes directors of the company. They have a very clear conflict of interest. What must happen is the board, or possibly a special subcommittee of the board involving disinterested parties, must seize control and act in the interests of the shareholders to make sure the situation is resolved properly. This happened quite dramatically and publicly in the case of Alinta a few months ago.

Senator STEPHENS—I want to go to the issue of the relationship between private equity projects or groups and hedge funds and investment banking organisations and the whole issue of fees and the arrangements about due diligence. We discussed that before lunch with APRA and ASIC and they did not seem to be particularly concerned. Is that a concern for your organisation, the levels of fees that are being attracted through these arrangements?

Mr Evans—You can certainly see that there are large fees associated with doing these deals. You would have seen that in the case of the Qantas deal being proposed. There have been people who say that that is driving the whole process. I recall a piece of research done outside Australia, internationally, by McKinsey consultants. They found that the net return to the shareholders from private equity was not significantly different from that from public companies, but it was the gross return that was very different and the difference was being taken by the fees of the providers. That probably represents the relatively early stages of a wave of a new type of capitalism and the fees will probably be reduced by market forces, by competition. Whether it has led to any economic problems, I do not know. That is yet to be seen. I know people are looking for it, but I have not heard of anybody saying there is evidence it has harmed the economy.

Senator JOYCE—I apologise for being slightly late. I am going to ask a question that you might think is parochial, but it is a question a lot of people have in the pit of their stomach when

they think about private equity. In the advent of private equity, what are your views on the access of the Australian public to own a portion or a part of the assets of their nation and their connection to it, and their feelings of disconnection when we see something that is a iconic basically be taken out of the realm of where they can own part of that organisation? I am thinking of Qantas, obviously.

CHAIR—Is that a personal question or a question to the organisation?

Senator JOYCE—I am trying to reflect on an obvious aspiration that Australian people have, and I expect that they would expect us to reflect on this through this committee in the questions that we ask.

CHAIR—Not all Australians.

Mr Evans—I think it is a bit beyond the scope of what our members, who are directors of companies, concern themselves with. They act in the interests of shareholders and they may be domestic or they may be foreign. I do not know how greatly different it is from an unfettered market of listed public companies. These sorts of issues do happen, but I do not have any particular observation to make about it beyond that.

Senator JOYCE—Fair enough. On the issue of conflicts of interest and management lockouts, does your organisation foresee or believe that there are, envisaged within the public, question marks on the structure of fees that are associated with private equity buyouts, especially when the deciding party is the party that formerly had the duty of stewardship for the best value for the shareholder?

Mr Evans—There are two separate issues there. One is the issue of the level of fees, which Senator Stephens was inquiring about a minute ago, and the other is that of the conflicting interests of the various different parties. I think I should deal with the latter one mostly. This has been brought into sharp relief by the wave of large deals that has come up in recent months. One of these things can arise very suddenly. It may be that a company has had many possible deals going on that it has been considering that are perfectly legitimate ones, and this just seems like another deal. But, if it involves the interests of executives or officers of the company or of directors, they have to be set aside from the consideration of whether it is recommended to the shareholders or not. They must be; I do not think there is any question about that. A board—and this can be very difficult to do sometimes because of the close relationships between the people and the collegial working of a board—has to find a way to form a committee of disinterested members of the board who are not party to whatever the deal is that is being proposed and control the process. You cannot have people who have a personal interest. It would be contrary to provisions of the Corporations Act, but it would also be completely wrong in ethical terms. Our strongest advice to our members is: watch for these situations and, as soon as one seems to be appearing, the board must seize control in the interests of the shareholders and must act in their interests.

Senator JOYCE—In determining that disinterest, do you allow a balanced discussion that includes dissent to prevail and say that the shareholders can be a party to the musings of and the issues that are before the board?

Mr Evans—Within a board, there is usually lots of dissent, and there should be constructive dissent if they are acting in the interests of the company. That is their duty: to act in the best interests of the company. But, in doing so, people bring many different points of view. That is why you have a board and not just one individual. Constructive dissent within a board is highly desirable, as long as you do not break the rules of it still being a collegial body.

As for bringing the shareholders into it, there are really only two mechanisms for that. One is through the stock market itself, where shareholders will decide whether or not they will sell their shares, and the board will normally make a recommendation, whether it recommends that an offer be accepted or recommends that they do not sell because they can get a better offer or it is undervalued. The second is when there is a scheme of arrangement, which is sometimes proposed in these things—Alinta is an example. That has to be put to a general meeting and voted upon by the shareholders.

Senator JOYCE—That presupposes that the market has perfect knowledge, which obviously, on a private equity deal, would be somewhat circumvented, especially if people are looking towards their future.

Mr Evans—When the directors controlling the situation are acting in the best interests of the company, they would normally need to seek competing bids. The case of Alinta is interesting. The independent members of that board seized control of the situation and conducted a kind of auction, and they had competitive bids for the company—I think that is a proper course of action—to get the best value for their shareholders.

Senator JOYCE—Does your organisation agree with the role of APRA, in that they are an instrument that takes into account the national interest in the ownership of banks?

Mr Evans—I think that comes under the bank shareholdings act. I do not really want to comment on that. I do not have any view on it one way or the other.

Senator JOYCE—Does your organisation—and the answer to this is probably no, but I just want to get it on the record—have any views whatsoever on any sections of the economy that are of national interest?

CHAIR—With the greatest respect, Senator Joyce, I think—

Senator JOYCE—They might or they might not.

CHAIR—that is a very difficult question.

Mr Evans—Let me try to answer it, if I may. Actually, we think that what the directors of companies do in governing the companies of Australia is very much in the national interest—very much—and it has seen a stable and prosperous business economy, in the last few years particularly. I think Australia is regarded internationally as a country with soundly run companies, including its banks, and insurance companies and funds management organisations that are under APRA, and that that has contributed enormously to the wellbeing of the nation and to the retirement savings of all sorts of retirees.

Senator JOYCE—My final question—and I am sorry, but it is a Senate inquiry, isn't it?

Mr Evans—Yes.

Senator JOYCE—Your job ultimately is to get the best return for your shareholder. That is your task, whether that shareholder is one person or a million people. Therefore you would be very aware of the structures of ownership and the positions of the domicile of a company to extract the best return for that shareholder. That being the case, in the light of recent changes, if someone were to buy and sell basically a company that was formerly choses in action and predominantly goodwill, where would you be advising your shareholder to set up?

Mr Evans—You will see if you look at the statistics that the amount of inward investment, foreign direct investment, in Australia and the amount of outward are pretty comparable. We invest as much outside this country as other people invest into it, and that is actually a very healthy situation. We benefit in both directions. For the most part, we are completely indifferent as to who the parties in fact are that lie behind these things, but there are certain instances where the parliament has seen fit to pass a specific regulation in the public interest, such as on Qantas or the bank shareholdings act, but we recognise that those exist.

Senator JOYCE—I will be more specific, because it relates to private equity firms, and it would certainly be the advice I would be giving to someone if I had them in my office. Why would you advise someone to be domiciled in Australia if they could be domiciled in New Zealand and the purchase and sale of their predominantly goodwill asset would be tax free in New Zealand when it would not be in Australia? Why would you advise them to pay capital gains tax?

Mr Evans—We are a much larger and deeper and more diverse economy than New Zealand by far. You can see the very large number of companies that have chosen to be here rather than to be there.

Senator JOYCE—Thank you.

Senator WEBBER—Thank you very much for the useful information that you have provided to the committee, particularly for the description of the different roles and circumstances of directors in private equity as opposed to publicly listed companies. I have been looking at some of your guidelines, particularly the ones dealing with conflicts of interest. One of the concerns that have been raised with us is of course the lack of public accountability and scrutiny with a private equity company. Whilst it is good that you put this material together, what confidence can we have that directors of private equity companies do actually manage that conflict of interest, because they are not as publicly accountable as directors of publicly listed companies?

Mr Evans—It is a good question. The main point of conflict of interest that we have been focusing our attention on is during the change of control, when one of these deals comes along, when it may well be unexpected and where quite often managers or directors might want to have a personal interest which could be worth a lot of money to them. That conflict of interest during that period has to be managed with great care.

As for once the business is actually in private equity ownership, the directors are still subject to the Corporations Act in exactly the same way as any other director. So all of its provisions, including the provisions about conflicts of interest, apply to them and they could be prosecuted if they do the wrong thing. They are also in a market of a particular kind in their own right. There is a process of the constant raising of fresh funds for these sorts of people. I think Pacific Equity Partners is soon to close on a very large domestic fund. They have been in the market looking for money for that fund and they depend very much on their reputation as having delivered in the interests of their shareholders. The shareholders in a multibillion-dollar fund like that—it may include private individuals but, as I say, they are very insignificant—are by far and away pension funds representing ordinary people like all of us.

Most of the big funds reserve a small part of the money they have got on behalf of savers for alternative investment vehicles which include venture capital and private equity. I am on a venture capital board and we depend upon this kind of source of funds. They come from UniSuper, CSS/PSS—ARIA, as it is now—and places like that. Those funds use advisers and they put people on the boards of the private equity entities. So they watch very closely.

There is an accountability that takes place, but it is a very different kind because the assets are not liquid. I think the difference between this and the public stock market is that the public stock market is liquid: you can buy and sell shares any day of the week. The private equity market is illiquid. It is held off the market, but eventually the entities come back onto the market in some way because the funds need to realise their investment and pay out to their beneficiaries, or the people who placed money with them. So there is an accountability that goes through that—it is just not a very public one.

Senator WEBBER—An issue that has been raised in a lot of media commentary is that one of the difficulties we have with private equity companies is the different reporting requirements and the fact that we only really get to see things annually rather than with the regularity that we do for companies trading on the Stock Exchange. Therefore, it can take two or three years for us to realise some of the negative impacts of the investments or the decisions that were made in the first year. Is that a real issue that we should be concerned about?

Mr Evans—It has two sides to it. It has an enormous advantage. It is one of the reasons why people take companies into private equity. Very often they will want to do some form of restructuring of the company, and it might mean very fundamental changes to the business which, in the short run, would lead to a reduction of earnings. The stock market does not really like that at all. It reacts quite adversely to anybody whose earnings slip a little bit. It quite often marks them down very severely, even if there is a real prospect of additional value a couple of years out. Many companies go into private equity in order to do things that will depress earnings in the short term but raise the value in the long term. But, as far as the interest of the investors is concerned, the stock market of course has myriad small investors and they need to have constant information, but the private equity market is a small number of large investors and they get their reports. They will normally get reports on a quarterly basis on the investments that they have made through private equity funds.

Senator WEBBER—In reading the information that you have provided to us and the description you have given of the roles of directors of private equity firms and the direct representation and involvement they have, it looks to me superficially as though that would be a

lot more attractive a role than a director of a publicly listed company. So why would I want to be a director of a publicly listed company?

Mr Evans—I think there is some truth in that. Ten minutes ago we were talking about somebody who does not like being on a public company board, but I think he would be very happy to be on a private company board because he could focus on adding value to the company. I do not there is any shortage of people who are willing to join these private equity company boards. But it is very intense. You probably will not make any money unless the company is very successful at adding value. If you do add a lot of value to the company then you will probably make a lot of money. You have much higher stakes involved, both up and down.

Senator BERNARDI—I would like to follow up on what Senator Webber said. Do you have a comment on the accusation that could be levelled at public company owners and the directors of public companies? Public company directors have to meet investment expectations on a quarterly basis virtually. If their earnings are too variable then they are generally marked down by the stock market or they are not well regarded by the stock market. So, at the risk of alienating your entire membership base, do you think that public company directors are so risk averse that they are limiting the potential of the companies that they are in charge of?

Mr Evans—I am trying to think whether there is any evidence of that one way or the other. What I can tell you is that people do say, and I hear this regularly, that it is hard to take some measure which you think will pay off well in the long term but does not pay off well in the short term.

Senator BERNARDI—Isn't the evidence of that then the fact that private equity firms are generating returns far in excess of what listed companies are generally on an annualised basis over a seven, eight or 10-year period?

Mr Evans—I think the evidence that McKinsey found was that if you took out the fees that went to the operators of the private equity schemes then the net return for the investors in most instances was very similar to that of a diverse range of public companies. There are a few firms at the very top end of the league table of private equity firms who have made spectacularly high returns, but not very many.

Senator BERNARDI—I will come to the fees, because there has been a bit of talk about the fee structure, the incentives and the things driving some of these deals. Maybe you can answer this question; maybe you cannot. Is there a standard percentage fee that is appropriate to capital raisings in your experience?

Mr Evans—There is a convention in the private equity funds.

Senator BERNARDI—What is that?

Mr Evans—It will not always hold up; you have to test it when you are trying to raise the money. It is typically that the arrangers, the people who manage the fund, are paid two per cent per annum—that really pays to keep their office open and do their analytical work—and 20 per cent of returns, worked out on an internal rate of return basis, that are above 20 per cent. That is so-called 'carried interest': if you exceed 20 per cent then you get one-fifth of what is above that.

It is a convention. Some people might have been able to negotiate better terms; and some probably have not quite such favourable terms.

Senator BERNARDI—Those are similar to the terms of a lot of hedge funds, as they are described, rather than private equity funds. They are very similar. There are some listed investment companies that have a very similar structure. What about the headline fees? People talked about $150 million and things of that nature that were involved in the Qantas deal. The Qantas deal was a $10 billion deal—$150 million is a lot of money but it is only 1½ per cent. Is that a normal amount? If you raise funds as a public company then you could pay anywhere up to six per cent.

Mr Evans—I think it is different from the underwriting fees. It is similar to the fees involved in a takeover. If you arrange on behalf of company A to buy company B then company A will make a comparison—there will be a beauty parade of possible investment bankers to help it and they will talk about what their fees might be. They typically have a level of fees comparable to the one that you are talking about in the Qantas case.

Senator BERNARDI—So the bigger the deal the bigger the quantum of fees. It will work within regular parameters.

Mr Evans—I believe so. To get more detail on that you had better go to an investment banker rather than me.

Senator BERNARDI—I want to pick up on another comment that you made about the responsibility of directors to shareholders. Do directors have an obligation outside of the immediate return to shareholders in a takeover bid? Do they have an obligation to consider the new shareholders and the circumstances that they are putting themselves or the future of the company in, or do they only have to consider their existing shareholders and what is in their best interests?

Mr Evans—In the normal run of the life of a company, the duty of directors is to act in the best interest of the company. Exactly what that means for short-term versus long-term shareholders is quite a difficult thing for people to determine. One model, for instance, came many years ago from a doyen of company directors in Australia, Sir John Dunlop. He said that he thinks of the people who hold the company in perpetuity. That is quite useful because it enables you to say that you must take into account other stakeholders, such as employees. You have to have them. Customers, people who want to do business with the company, suppliers, the community et cetera have to be engaged otherwise the company will not have value in the very long term. There are other schools like Warren Buffet's—and he is a very famous investor and much admired from America—which tend to be interested in short-term value adding of the company. They are interested really in people who are holding the shares for a limited period of time—under 10 years. A very different circumstance happens when a takeover is occurring. The people whose interest you must act in are the shareholders at the time and not future shareholders.

Senator BERNARDI—It is interesting that you mention Warren Buffet. While Berkshire Hathaway is a listed investment vehicle, the bulk of Buffet's success has been through buying companies and owning all of them. Is that fair to say? I am not asking if you are an investment

analyst, but he has certainly taken large stakes in private and public companies and then taken them private.

Mr Evans—He has managed such enormous amounts of money. He often takes significant but not controlling stakes—for instance in Wal-Mart—and he judges which ones will have further value in the future and goes with his judgement.

Senator BERNARDI—So he could not be regarded as a purely private equity investor.

Mr Evans—No.

Senator BERNARDI—But there will be a portion of his investments, I guess, that could be described as private equity, given that they are 100 per cent owned vehicles.

Mr Evans—He runs Berkshire Hathaway itself, but you will have to go to him to find out exactly how it works. I am not quite sure.

CHAIR—While giving evidence this morning, the RBA gave us a graph of exits of private equity investments. I do not know whether you have seen that or not, but as a rough rule of thumb it looks like about 80 per cent of those exits are by way of IPOs or trade sales. I assume that directors of private equity companies would have a level of discipline and a relation to their activities generated by the most usual form of exit back into the market place where those activities are going to be laid bare at some stage by either a trade sale or an IPO. Is that a reasonable take of the situation?

Mr Evans—Yes, that is right. It is normal for directors of a private equity company, or a company owned in private equity, to be aiming for an exit point at a finite time in the future—it is typically three to five years but sometimes it is shorter and sometimes it is longer—so as to realise the greatest possible value for the business. In doing that they are acting in the interests of their shareholders; that is what they are expecting. They may well be acting in their own interests as well because they are likely to have a direct interest in the business themselves.

CHAIR—And, if you add in the management buyback—it is a bit hard without having the percentages—of roughly 10 per cent in there, we are looking at about 85 per cent under those three exits methods—I would presume that the matter will be lifted very quickly in relation to those three exit methods; therefore, there will not be much point in sweeping stuff under the carpet because at some stage there will be exposure of those activities?

Mr Evans—Far from it. That is a very direct drive to maximise the value of the business.

CHAIR—Can you just give the committee an overview of the membership of your organisation?

Mr Evans—The AICD is a member institute whose activities are about promoting the principles of good directorship. We have a handful less than 22,000 members. That is clearly well above the number of directors of the big public companies, because there are only 1,000 or so of them. About half the number of directors of the top 200 public listed companies are members of our institute. Many people are directors of lots of other things—unlisted companies,

smaller listed companies, foreign subsidiaries, superannuation funds, charities, schools and such like. You will find that any organisation which has a board of directors—or something akin to that—and which has collegial decision making that is typical of a board are members.

Senator JOYCE—Do they all have equal voting rights?

Mr Evans—In our organisation, yes. It is just on a membership basis. We run a large scale education program for directors. The main item is a course for company directors for five days. About 2,000 people attend that every year. It is a fairly large scale activity. There are also more advanced and less advanced courses. We hold many meetings with speakers and engage in a certain amount of policy and advocacy work.

CHAIR—That was my next question. What is your view of the level of awareness of company directors of the Corporations Act and their requirements under the Corporations Act and also licensing requirements under ASIC? How would you rate the level of awareness of the Corporations Act?

Mr Evans—It is very high among the directors of companies of any significant size. They all know it is there and they have to act according to it. Some people at the small end of privately held companies, and even some small listed companies, will be less aware. But that is what we teach in our courses and many people go through the courses.

Ms Upton—Going back to the topic of this inquiry, our role in terms of education and leadership has led to some of the materials that you have in front of you. The issue that we have focused on most, which Ralph Evans has spoken to previously, is recognising that conflicts of interest can arise in private equity. To address our objectives of education and leadership, we put together materials in the vein that Ralph has spoken about more generally on company directors' duties, to educate our members, to provide some guidance about what they might think about in advance of a private equity bid or participation in it. Some of those materials are before you in the supplementary folder.

Senator JOYCE—Seeing that you are involved in policy, do you believe that we have the appropriate level of transparency for corporations? Do we have too much or is it not enough?

Ms Upton—The view that the institute would have is that there is an appropriate amount of regulation of companies and directors. Particularly if I can bring it back to the terms of the inquiry, the view expressed in our submission is that there is a lot of law, both Corporations Law and statute law, which has existed for quite some time, that underpins the obligations that directors have and the actions that they should take in situations of private equity bids and some of the issues that flow from that.

Senator JOYCE—That makes you a very effective advocate because that is exactly what we have.

Mr Evans—I do think that the system is not broken.

CHAIR—By that I take it that you are indicating to the committee that you do not see the need for change either legislative or regulatory—certainly, no increase in legislative or regulatory intervention.

Mr Evans—I do not think that the wave of private equity has pointed to a particular need for change in the law.

CHAIR—There has been some evidence given in some of the submissions, which I do not have in front of me, in relation to the view that the norm is a continuity of management post private equity buyout and that the view that a very large broom goes through is not evidenced. There is also a view in some of the evidence that has been given to us that employment tends to increase rather than there being wholesale slashing of jobs. Is that the experience of the institute?

Mr Evans—The continuity of management is because of its value. There are circumstances sometimes when it does not continue. We have seen a removal at the top level of Alinta, for instance, because of the involvement in the deal that was being proposed. That is not a good thing for a company at all. As to whether the rest of the employees other than those at the very top are affected, I think it can happen both ways. Sometimes there is investment and the companies grow; sometimes there is cost reduction and they shrink.

CHAIR—There was also some evidence in one of the submissions that, while we talk about large fees, they are often taken as equity not cash. Is that your experience?

Mr Evans—I cannot think of a case of that, but it may be. It is a bit beyond my scope.

CHAIR—Okay.

Senator BERNARDI—I have a further question about regulation, compliance and things of that nature. Do you think that a reduction in regulations and compliance might have the effect of freeing public company directors to concentrate more on building and growing their business to the benefit of shareholders making them perhaps unlock the potential of the business to a greater extent and making private equity deals less attractive?

Mr Evans—In a couple of weeks time, a new version of the ASX's corporate governance principles will be released by Mr Pearce. That comes from the ASX Corporate Governance Council, which we participate in, and it has been going on over a number of months. The new code is actually somewhat clearer and simpler and I think does allow directors to pay more attention to the future of a company and less to what I might describe as form-filling or box-ticking types of compliance. That is a good thing.

CHAIR—Thank you very much for your attendance and your contribution.

[2.35 pm]

JONES, Mr David Fletcher, Chairman, Australian Private Equity and Venture Capital Association Ltd

WOODTHORPE, Dr Katherine Lesley, Chief Executive, Australian Private Equity and Venture Capital Association Ltd

CHAIR—I welcome representatives from the Australian Private Equity and Venture Capital Association Ltd. As these witnesses have not appeared before a committee before, I will give the abridged version of the opening statement. These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind you that in giving evidence to the committee you are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness shall state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground on which it is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may, of course, also be made at any other time. Do you have any comments to make on the capacity in which you appear?

Mr Jones—I am also Managing Director of CHAMP Private Equity.

CHAIR—Thank you. I invite you to make an opening statement.

Mr Jones—I would like to make a brief statement. AVCAL welcomes the inquiry and the opportunity to appear before you today. We do feel this is a timely opportunity for a fact based discussion about private equity. We are here to answer your questions and we will not go over what we have already provided to you; however, before opening for questions I would like to make four brief comments about how I see the role of private equity in capital markets and the Australian economy. In making these comments I note that this inquiry is focused on later-stage buyout activity, but it is our view that a number of the themes here are also relevant for early-stage venture capital investing.

Firstly, I would like to highlight what private equity actually does differently, which is in essence two things: we form an active partnership with management, resulting in the very close monitoring and challenging of performance, in a high level of accountability and in rapid decision making, with shareholders and management all around the board table; and, we focus on investing with a three- to five-year view. This focus means that we can invest in initiatives that may not see an adequate return for, say, three years. This is in contrast to some companies that become fixated on the near term, on the next quarter's or half's earnings and on equity analysts' assessments.

So private equity brings two things: engaged leadership and capital. The capital that we bring is the fuel—the energy, if you like—that drives the increased growth that private equity typically delivers in the companies that it backs. This capital is injected into businesses for capital expenditures, acquisitions and new product development. This fuel is how private equity generates jobs at typically well above national averages—as highlighted in our submission to you, which I hope you have all had a chance to see—and this drives private equity's superior returns for Australia's superannuants. The Thomson Financial survey to June 2006 shows five-year returns for Australian buyouts at 17.7 per cent compared to the ASX All Ordinaries Accumulation Index of 12.3 per cent—so a 5.4 per cent outperformance over that five-year period. It is our view that this access to capital is at the heart of our model, and yet it is often overlooked in the commentary. It is capital beyond the purchase price that we actually put into the business.

Secondly, private equity is only relevant in certain circumstances. This may come as a surprise to you but it is our view that most businesses attract and maintain both these factors that I just cited: adequate capital and adequate management attention. In these situations it is our view that private equity is actually relatively less relevant. It is only when private equity forms the view that a business lacks adequate management engagement and/or optimal capital that private equity considers whether it can improve performance. It is in this minority of situations where private equity can act as a catalyst for change and propose a new direction for a business to its owners.

Thirdly, private equity's relevance in only a minority of situations is why private equity is a small part of the economy, as is borne out in the statistics. As you would have seen in our submission, private equity investment in Australia represents a small part of merger and acquisition activity, at around 20 per cent; a very small part of the value of the Australian Stock Exchange—1.4 per cent of the enterprise value of the exchange last year; a small part of bank lending, at under three per cent; and a small part of the superannuation fund industry, at well under five per cent. The more developed private equity markets in the UK and the US are not markedly different.

But, importantly in our view, in spite of this small size, we do contend that private equity plays a very useful stimulatory role in the Australian economy. We provide a real challenge to businesses to strive for active, engaged management and for the disciplined investment of capital. Importantly, this not only applies to businesses backed by private equity but also to many other businesses, since most boards are aware of private equity's presence in the business community. In addition, whether private equity is successful or not in a proposal to invest in a business, its approach to a business can nonetheless cause the owners to reconsider their current management practices and their views on value. We have seen many instances where private equity's approach, although unsuccessful, has caused a rerating of a company, benefiting the current owners.

Finally, in terms of regulation and oversight, we feel the current system works very well. The recent increase in private equity activity, we would put to you, has stress-tested the Australian system at many levels. We note the helpful reviews this year on private equity from the members of the Council of Financial Regulators, whom you saw this morning. We contend that the responses of our agencies and bodies to the recent rise of private equity activity, including this inquiry, shows the robustness of our system. For example, the Takeovers Panel, who I know you

are meeting with tomorrow, released a guidance note in June of this year, in which I was asked to participate, called 'Insider Participation in Control Transactions'. The panel assessed that it would assist in providing further clarity for boards in dealing with the situations where their existing managements may be offered ownership in their businesses in the future.

More generally, we have not seen any reasonable assessment of private equity's role either from here or from overseas that suggests any major review of regulatory overlays or risk approaches is warranted. Indeed, I note the recent success of public companies in beating private equity in a number of transactions and of shareholders deciding to keep owning assets themselves and rejecting a private equity offer, even when it is at a substantial premium. This says to me that the current system of shareholder democracy is working well and that owners of businesses have responded appropriately to private equity's emergence. Looking to the future, we anticipate that while private equity activity will grow and continue to contribute positively to the Australian economy, it will remain a small part of the overall public market. With that, Chair, I welcome this inquiry and the opportunity to assess private equity's effects on capital markets and the Australian economy.

CHAIR—Thank you, Mr Jones, and also for your first appearance; it was very impressive.

Senator WEBBER—Thank you for the opening statement. You have given us an outline of the useful role you think private equity can play in the market. Are there any emerging trends looking forward? We had evidence from the Reserve Bank today saying basically that they do not think that private equity investment in Australia is going to keep going up in the way it has been, and they showed us a number of graphs. What is your view? Is that right? Is the market now contracting?

Mr Jones—I do not think it is contracting. I think the outlook remains quite strong. We have a real and genuine role to play. It is our view that we are now an established part of the landscape and we expect that will continue, but again it is in the overall context of being a small but, we think, positive factor for challenging existing companies and seeking opportunities to rejuvenate existing businesses. That is really our role and we expect that will continue.

Senator WEBBER—And continue at about the share of the market that it has now?

Mr Jones—I expect it will continue at similar sorts of shares to where it is today. Looking at the US and UK markets, the key statistics are not markedly different, and they are more developed. I do not see markedly different trends happening, no.

Senator WEBBER—In your submission you mentioned that one of the positives of the involvement of private equity in the market is potential job growth. One of the concerns raised a lot in the media commentary on the attempted Qantas deal was about job losses and jobs going offshore. So where would the job growth come from?

Mr Jones—I cannot comment on specific transactions that I was not involved in.

Senator WEBBER—That was part of the commentary, so obviously people were concerned that private equity buyouts may lead to jobs going offshore, yet your submission says there is potential for job growth.

Mr Jones—What I would say to you is that Australia competes with cheaper labour countries across the board, and all of our businesses do. I do not think it is any different for private equity backed businesses. I think that both here and in every other market where a thorough survey has been done the statistics show that private equity backed businesses have typically generated markedly greater job growth than the general economy or the general set of listed company results. Highlighted in our submission are a number of surveys to that effect—the Pricewaterhouse study that we did here, a bunch of studies in many of the European countries, a pan-European study, and a North American study. Private equity backed businesses compete for jobs and for talent in the same way that any other businesses do. We think it is pretty clear that we have a stronger than average job creation record. We expect that will continue.

Dr Woodthorpe—I think that tomorrow you are seeing tomorrow Brian Hodges from Bradken. His story would be very illustrative of such a thing: a manufacturing industry, which you suspect would go offshore quite often, where there is competition from cheap labour, has demonstrably added a number of jobs in Australia and in an area where that is less likely to happen. Even in industries where we understand that jobs can often go offshore we can clearly demonstrate that they can also be kept onshore and companies can grow and add value here in Australia.

Senator WEBBER—Are the concerns that have been raised here about both the lack of public accountability and transparency and the way in which we manage conflicts of interest within private equity investment warranted?

Mr Jones—They are both very big issues. It is our view that there are very important issues around the potential for conflicts of interest whenever an existing manager or director of a business, when he has a clear duty to the owners of that business, moves over and works for the next owner. That is a clear area of conflict that needs to be dealt with very carefully by the board of the company.

The matter is clearly laid out in the Takeovers Panel guidance note, which, as I mentioned, I participated in, that the right way forward is that, as soon as an approach is made to a company manager, it should immediately go to the board and to a subcommittee of the board to manage that process and keep the potentially conflicted manager out of that process until the appropriate time. If that is the matter you are getting at, it is a very important and very delicate matter, but I feel the path to manage through it is relatively clear, and I think that is what the guidance note sought to do. On the question of transparency, I would be interested to know what elements you are specifically getting at. Unfortunately, I was not here for this morning's discussion. Could you elucidate?

Senator WEBBER—It is just that a lot of commentary is made that, if you are a publicly listed company, therefore we get to have almost day-to-day judgment in terms of the decision making and practices of that company; whereas, if it is a private equity company, all most of us get is the annual report—particularly if it is our superannuation company or what have you that is investing. We do not actually get that public accountability of some of the more risky decisions that are taken.

Mr Jones—We have a reporting guidelines regime that we promulgated at AVCAL three years ago and which it is compulsory for all of our members to comply with. That regime is

consistent with the global standards, so it is sort of a superannuation industry standard reporting approach.

Senator WEBBER—Whom do they report to?

Mr Jones—We report that quarterly. All of our companies go through a very careful process. There is also a standard around how we value the investments that we have made. We value them quarterly, send a lot of detailed information back to our superannuation funds and then it is up to the super funds how they communicate that back to their members. We tell our super funds, and they know, that we actively monitor our businesses, as I touched on in my opening address.

I think the super funds would tell you that quarterly information is more than enough, given that we are a small part of their portfolios and within that they might have money with 10 or 20 managers and each manager might have 10 or 20 companies. They feel that getting a quarterly report from each manager is more than adequate visibility for them around how their investments are performing.

Senator WEBBER—Is there any sector of the Australian economy that is not suitable for private equity investment?

Mr Jones—That is a very general question. I think private equity is about being creative and, as I said, seeking to find businesses that they think can be rejuvenated, renovated, improved, stimulated or challenged, often with capital, to push the business forward. There is no doubt that some businesses are less naturally suited to our style of approach. There are some businesses that are too large or have different characteristics. Private equity is always seeking to evolve its opportunity set, but it is difficult to be specific, and I guess it goes to the philosophies of individual firms for the sorts of businesses that they will seek to support.

Senator WEBBER—Thank you.

Senator JOYCE—I have a couple of questions. Some of the things I will say are for the purposes of the *Hansard*; I know you understand them completely. If you put $1 towards a $100 company, and you sell it for $101, you have obviously made a 100 per cent profit; but if you sell it for $99 you have made a 100 per cent loss, by reason of leverage. Do you acknowledge that the advent of private equity into the marketplace has the capacity to accelerate your upside but also that, ultimately, at some point in time we are going to have a market correction? We have been talking about Warren Buffet and value investors. If we believe in that, we believe that there is ultimately going to be a market correction. At that time you will have exacerbated your downside.

Mr Jones—If we were using leverage to 99 per cent, I would be very concerned. That is not what we are seeing in any of the statistics. The average percentage of debt to equity in private equity deals over this decade—and it has not changed even as the deals have grown substantially in scale over the last 12 months—is around 30 per cent equity to 70 per cent debt. So there is a substantial equity buffer, unlike in the 1980s when deals were up to 80, 85, 90 and even 95 per cent debt. Back then the banks were taking equity risk for only a debt return and that did result in a very difficult outcome. That is not the scenario here. Private equity is taking that risk, and that

risk exists when you buy anything for $100. It might go down and someone is going to take that first dollar of risk. That is the equity; it is not the debt. There is quite a buffer there. In your analogy, there is $30 of equity before there is a dollar of debt at risk.

Senator JOYCE—Acknowledging the 1980s scenario or, for the sake of argument, the 1929 scenario, how do we determine the transparency to monitor that impact on the economy? Currently, there would be complete transparency and an ability to cope with the inevitable downturn that will happen in the share market at some stage. It will flush itself out and go on. But with a private equity firm we have stranded assets in the liquid private equity firms that will be a retarding influence on the economy. When we look at something like the RBA graph and we see things that have gone up by 100 per cent, 33 per cent and 50 per cent, we know that what goes up must come down. Somewhere it is going to go pop. How do we deal with stranded assets that could become lodged in private equity firms in a downturn in the market?

Mr Jones—The real stresses in the system occur when there are stresses in the banking system. What has been very pleasing to me in the recent 12 to 24 months—and I have been doing this for the last 13 years—is that Australian banks and, to a lesser extent, foreign banks participating here have kept that debt to equity discipline around, again, this ratio of around 30 per cent equity within the deals. So, if there is a major correction and there is a 10 per cent or 20 per cent diminution in the value of an asset or a group of assets, that is absorbed or taken up by the equity and the debt should remain whole.

Senator JOYCE—I am trying to drill down to the area. You say the number for equity is 30 per cent. What is the transparency or monitoring mechanism so that those people who work in Treasury or wherever else who have some position over the benefaction of the wider Australian community know that you are telling the truth about the flow of information back so that we are forewarned and forearmed? Without it, we are just trusting you. While trust is a great thing, sometimes people are untrustworthy.

Dr Woodthorpe—I think APRA this morning commented that the information they garner from the banks gives a lot of transparency about those sorts of debt levels. Although on an individual deal-by-deal basis there is not the transparency from the private equity companies, at the other end of the spectrum, from the lenders' side, there is great transparency. APRA were very sanguine about that issue and about having a good handle on those numbers.

Senator JOYCE—So we are relying on the transparency of the debt instrument, basically.

Dr Woodthorpe—Yes. In terms of your whole question about the macroeconomic impact if things were to get tighter or go sour—1929 or whatever all over again—one thing that we have stressed and which indeed all three regulators stressed this morning is the proportion of private equity as a part of the whole economy. If you compare it to the ASX, we have come up with about 1.4 per cent and ASIC came up with 1.7 per cent. They are all in the same sort of order. Private equity in the whole macroeconomic scale is of a very small proportion. If, for whatever unusual and unlikely reason, things were to get particularly difficult, the macroeconomic impact would be minute.

Senator JOYCE—But it all depends on what sectors that 1.5 per cent is invested in. You can have 1.5 per cent investment in a certain sector which can be most of the sector. For instance,

using the Qantas example, it might be in a small part but the effects of that coming unstuck would have been devastating for the Australian air transport industry.

Mr Jones—I will add one further comment regarding your question about stranded assets. Our firm and other firms that I am aware of have tended to have extra equity capital to put into struggling assets. Having a vibrant private equity industry can be a very useful mechanism in a downturn, because we are there to recapitalise our business. I can list a number of businesses that we have put more equity into to try and help them ride out a particular downturn and then take the business on. While fortunately the Australian economy has not had a proper downturn for some time, the history of private equity overseas—and ours here back in the late 1980s and early 1990s, when there were some very difficult times—has a number of examples which the private equity industry could point to where liquidity was added. We are adding another market for assets to change hands in. If it has the wrong owners, the wrong leadership and the wrong capital structure, we can restructure and/or trade the asset to someone else without having it go all the way down. You know as well as I do that when some markets, like public markets, get it into their heads that things are going down, everyone bails out and there is not anyone standing.

Senator JOYCE—I agree with that. That gets back to your 'animal spirits'. Who is your membership?

Dr Woodthorpe—Our members are the providers of private equity and venture capital in Australia. Around that core of members who are active participants, there are the service providers in another form of membership—a kind of associate membership, you might say.

Senator JOYCE—In that inner sanctum of members—I do not want to know their names—but have we got—

CHAIR—They are all here, Senator, in this document.

Mr Jones—They are all at the back of submission.

CHAIR—They include the Queensland government, Victorian departments—

Senator JOYCE—Now you are in trouble! So it includes the Queensland Industry Corporation?

Mr Jones—Yes.

Senator JOYCE—What is your view on the position that many shareholders will have where they feel that in the advent of a private equity takeover they are now in competition with their directors? Shareholders believe that they have perfect knowledge, but they do not; the directors have more perfect knowledge than they do, and the directors are putting themselves in a position to be a beneficiary of the knowledge that they have over their shareholders. You might say that they would never do that, but in light of what has happened to the share price of Qantas—it is most topical because it happened lately—shareholders might turn around and ask: 'How could they have been carrying out their duty of stewardship when the price of my share is now in excess of what they were offering me?'

Mr Jones—It is difficult to comment on specific examples that we were not involved with. It is pretty clear that directors have a duty to seek to maximise the returns for their shareholders at all times. If a bid comes along for a company—be that from a private equity firm or from anyone; if Rinker or CEMEX show up or whomever—it is the board's duty to assess that bid based on the prevailing prices at that time. In the example that you have raised, the bid was at a material premium to the previous prevailing price. This is an example of shareholder democracy working—

Senator JOYCE—A very smart fund manager working.

Mr Jones—just, I will add—the shareholders deciding no and the company being rerated by the market. So, if we did not have an active private equity industry, who knows—that company's shares might still be where they were prior to the approach.

Senator JOYCE—What advice do you give to your current companies on conflicts of interest when you initially make a move towards a company?

Mr Jones—We seek to glean as much information as we can through publicly available sources about the business—just like any other shareholder or corporate raider, whether it be CEMEX or whomever—and then we approach the company. We and all of our members are very well aware—I participated in this Takeovers Panel review but even prior to that I think our industry was very well aware—of the conflict that you can immediately create, particularly with a chief executive, when in 99 per cent of Australian transactions we back the existing management to continue to run the business for us. What typically happens is that, as soon as the conversation starts, it goes straight to the board.

I think you used the term 'animal spirits' earlier. I will give you an analogy. If we talk to a manager who winks and says, 'I will give you the inside word here,' we think to ourselves: 'He's going to be selling this business for us in three or five years time and he's going to be winking at the next guy. I don't know if that's the sort of person we want to back.' People are people and things happen, but it is not generally an approach that we encourage at all. Very quickly it must and it does go straight to the board and the board handle it. It is very rare that directors participate on both sides. With management it is quite common, but not so with directors; hence, the board handles the process.

Senator JOYCE—Finally, looking at page 2 of the RBA graphs, they are placed here to allay our fears, and we see that Australia is way down the bottom, at about $4 billion, and America is up the top with about $414 billion. One could turn that on its head and say there are immense funds floating around there and, if those funds were to find their way into the Australian market, they would have an immense effect on our market. They do not have to purchase everything on the market. In fact, they would be very discerning in making sure they did not. You are very clever people and that is good—God blessed you with brains—but you would be purchasing the assets that are worth while and therefore leaving behind the assets that are not, and you would have a second rate pool of investment left behind. Is there anything to stop a large flow of funds from the United States saying: 'We'll take over BHP, we'll try and find ourselves Coles, we'll pick up Woolworths while we're at it and we'll merrily make our way through the top 10. The only things we won't touch are the banks. We'll leave the rest to you'?

Mr Jones—I guess there are two things I would point to as to why I am really not concerned about that. Firstly, shareholder democracy works. No-one can just come in and say, 'I will buy your business.' The directors on behalf of the shareholders and then ultimately the shareholders need to form a view about value. We have already seen here a bit of a reaction where people are going, 'Well, if these private equity guys think this thing's valuable maybe it is.' And you get a rerating and a reassessment.

Senator JOYCE—I agree with that.

Mr Jones—That is not a bad thing. Is there anything to stop that happening? Yes. If you like someone's house, you cannot just buy it; that person has to sell it to you. I think that is the first test.

These numbers do look large, and these charts are roaring up to the right hand corner, but we have to keep it in context. Almost 80 companies were taken off the Stock Exchange last year. Two of them were privatised through private equity, and over 180 new IPOs were listed last year on the Australian exchange. So we are just not seeing it. In the US it was less than one per cent. In the UK it was less than one per cent. So we are happy to have a conversation if it gets to 10, but I just don't see it—there is nothing to show. We have a very firm view that globally the public company model works and that we are only relevant, as I said in my opening, when we feel a business has been under-nourished and under-led and we think we can form a different approach, but I think that it is the strong minority of situations.

Senator JOYCE—Obviously, most organisations, especially professional organisations, to circumvent any aspect of government regulation, become self-regulatory and encourage people to become a member of their organisation and say, 'This is how we circumvent the government having to stick their noses into our business. We will set up the regulation to do it ourselves; you can be part of this or not be part of it.' They are usually pretty successful. Do you find that people want to comply and participate in your organisation and do so in a manner that also satisfies the desires of this nation to be a very safe ship into the future?

Mr Jones—I am very sanguine about the role that our organisation plays. Our membership is very engaged. We have an active council from the manager members. Also, some of the superannuation fund members are on our council, so they are giving us perspectives from their side about how our industry is managing their money for their participants. I am confident that this industry body is well engaged. We have met with all the members of the council of financial regulators during this year, because obviously we have been relevant. We have been engaged with the Takeovers Panel, as you know, and we expect that we will continue. So I think this is the right forum. We do have all the local players and the foreign firms who play here. They are all members. They all subscribe to our valuation guidelines, to our reporting guidelines. We are not running a police state, but we are confident that they are diligent members of our community. It is a broad church, so we cannot speak for everyone and everyone does not exactly march in step, but I am confident that we do have a useful association here that can help in this discussion.

Senator BERNARDI—Of the private equity firms based in Australia, how many are there outside of the venture capital spectrum, like the mature leveraged buyer?

Mr Jones—We have 58 members, and I would guess—

Dr Woodthorpe—Fourteen or so are venture capital.

Mr Jones—So call it 40-ish or—

Senator BERNARDI—Okay, like Pacific Equity Partners and KKR and all of those.

Dr Woodthorpe—But also a number of smaller ones who are operating at the mid-market level.

Senator BERNARDI—How many have gone broke?

Mr Jones—There are a number who have failed to raise further funds.

Senator BERNARDI—Is that how you describe going broke?

Mr Jones—It depends what your definition is of going broke.

Senator BERNARDI—They have closed up shop and everyone has lost all their money.

Mr Jones—I don't recall examples where people have lost a lot of their equity return. There are some funds that have done poorly. This is what happens in our business if your fund does not beat the bench mark. Private equity is relatively illiquid. You've got your money in for up to 10 years. So we are required to return a premium over, for instance, the stock market returns. If you only return the market return, or below that, or if you return zero and people get their money back, that is a pretty poor result. People may get their money back, but you will not raise a new fund. That is what has happened. We have seen a number of managers transition out of the business because they have had a particular strategy or they have had bad luck or whatever—they have just chosen the wrong horses.

Senator BERNARDI—But it has not been a catastrophic failure?

Mr Jones—Not at all. That is why I gave the highlight that, on average, buyout returns have been about five per cent over the stock market returns across Australia. The venture industry has been slightly weaker because earlier stage businesses have found it harder to get critical mass in this market.

Senator BERNARDI—What about the circumstance whereby a business is purchased, and due to circumstances the 30 per cent equity component is eroded over time? Does the fund—a successful fund or otherwise—go then to its investors and say, 'Look, we think there's still hope for this; we've just got these circumstances; we want to stick a bit more money into it'?

Mr Jones—Yes.

Senator BERNARDI—Are there those sorts of buffers that go on?

Mr Jones—That is what typically happens. I have a wry smile, because that is exactly what happened to my last fund. We had a portfolio of firm—

Senator BERNARDI—What, you made a bad investment?

Mr Jones—We were all doing well and, as in any family, there was one problem child. We have capacity written into our trust deeds to put more capital in. The old cliche exists about putting good money after bad, but in that scenario we put capital in and the business is still running. It now has a new owner.

Senator BERNARDI—In the mature age buyouts, how many of the individual deals go sour after they have been put into play?

Mr Jones—Very, very few, because they are already established, mature businesses. There are some that do not do so well—you might only get the stock market return or they might only get their money back, or maybe you take a small equity loss—but that is relatively rare, so in a portfolio of 10 deals you may only have two or three that are below average. In a mature fund, you would be upset if you lost money on more than one deal. In an earlier stage fund, where your upside when you have a stellar return is that you make many multiples of your money, you do have many more zeros—

Senator BERNARDI—That is why I am confining it to the larger ones, because that is where the risk is, whether we are talking about national interest risk or risk of icon companies and so on. One that springs to mind is Myer. Myer was sold by a publicly listed company in Coles. It was sold to a private equity group.

Mr Jones—Yes.

Senator BERNARDI—It returned an enormous increase in profits, I think. But did they do that by retrenching staff or closing stores or—

Mr Jones—No.

CHAIR—To the contrary, I think they have opened a large number of new stores.

Mr Jones—They are actually opening stores. We were hoping to get the executive chairman of that to speak you tomorrow but he was not available. That has only been in private equity hands for 18 months. It is still owned by private equity, so it is still a work in progress, but the track record so far is very, very good. As the chair says, they are opening stores. They have improved profit through more engaged management, bringing capital to the business. They are spending more on marketing. They have rejuvenated their brand. They have closed down a bunch of their supply chain, so that they have a more streamlined business with lower costs.

Senator BERNARDI—So you do not make money simply by slashing jobs and overheads; you are actually trying to build a business?

Mr Jones—That is precisely my point. It is our view that very few people shrink to prosperity and that, yes, we bring disciplines to our businesses; yes, if there are excesses, we will be actively seeking to cut them out, but, as I said in the opening statement, we think we do bring fuel to these businesses in terms of capital for new stores, for new warehouses, for new practices

or computer systems or for whatever might be part of our thinking to rejuvenate that particular business.

Senator BERNARDI—I turn now to another topic: taxation. The loss of taxation or threatened loss of tax dollars to the Australian government has met with some discussion. Some people are a bit more alarmed than others. Is there a difference in the way private equity firms treat their taxation obligations? Do some treat them as capital and some treat them as income? How do they account for them? Is there a consistent approach across the board?

Mr Jones—I am not privy to what every firm do in terms of their affairs, but I think as a general rule our industry globally sees ourselves in the capital gain business. We put money—including ourselves personally—into these transactions. That capital is at risk. And then eventually—in three years, five years or at the end—we have one shot to get our gain back. We typically do not pay dividends out to any of our shareholders. We typically just sell the business at the end. So we have always approached this as a capital business.

Senator JOYCE—I might be one of those people a bit more concerned than others. In a fashion, the ‘capital gains business’ is sort of an oxymoronic statement because it presupposes that your business is buying and selling assets. If that is, first and foremost, your mechanism for making money then that would at least raise the suggestion—and I know it is not going to be changed—that what you are doing is income in nature not capital in nature. The buying and selling of the private equity firm may certainly be capital in nature, but what the private equity firm does to earn money would have to suggest that at some stage it might be income in nature.

Mr Jones—We charge management fees along the way to pay for our costs—our office, our expenses of due diligence et cetera. They are all income and that is how we run our business day today. But then the other component to our business is the backing of the companies and that is—

Senator BERNARDI—I would like to ask a question on that. We mentioned earlier the two per cent management fee and the 20 per cent fee. Is that a carried interest in the business or is it a cash payment for achieving in excess of particular benchmarks in addition to whatever you put into the business from the private equity investment perspective?

Mr Jones—It is our share of the gain.

Senator BERNARDI—After previous benchmark hurdle arrangements?

Mr Jones—Yes, and after we have paid back all the other fees. So after the return and any other fees and charges have been earned after a benchmark—if there is a benchmark hurdle.

Senator BERNARDI—Amongst the bigger players, the ones who are mentioned as doing $20 billion deals and having that sort of capacity, and given that there is a national interest provision for the Foreign Investment Review Board which has been used in some bids previously in the case of Woodside, is there a recognition amongst those players that there are asset classes or areas of particular Australian assets that are just not worth getting into because it is going to be too hard and is unlikely to succeed?

Mr Jones—Of course. Absolutely. I think we are like any other potential purchaser—like CEMEX or whomever it might be; any other foreign private equity firm, for example. Like any other regulation it is there for a purpose. I think, generally speaking, our industry has the highest of respect for it. So if there is a FIRB issue then absolutely. At my firm some of our funds come from overseas. So we have to go through FIRB to get approval for all of our deals. We are very familiar with the process.

Senator BERNARDI—Let us use the hypothetical Woodside example. If you are going to have a tilt at Woodside, are you going to invest $20 million of your fund's money to do the due diligence and everything else in the knowledge that it is highly unlikely that you are going to be granted permission to do it?

Mr Jones—At the end of the day, we are commercial people and we look at the probability of success of everything. If we deemed that to be a material factor then that would obviously weigh on our considerations.

Senator STEPHENS—Thank you for your submission. It has a very different tone to many of the other submissions we have received. You have addressed the terms of reference, which has been helpful. In your 'Facts at a Glance', on page 5 of your submission, I am specifically interested in the points you make about generating jobs, increasing business revenue in exports and productivity and innovation. I would like you to elaborate on those points and how you feel you are able to make those claims, and then I want to talk to you about the comments you make at the end about taxation.

Mr Jones—In terms of the productivity—and Katherine can help me here—we have a number of sources, so it would be difficult to give you a generalised answer. Firstly, you should look at pages 19 through to 22 of our submission. On page 20 are the studies from overseas around job growth. The chart on 21 is a terrific study that the European Venture Capital Association did around four key measures of stimulating business. This funny little one around cap ex, marketing, training and R&D on page 21 of our submission—you are looking perplexed.

Senator STEPHENS—Is that chapter 9?

Mr Jones—You must have different pagination. It is in section 6.

Senator STEPHENS—Okay.

Mr Jones—So page 2 of section 6 has the four bar charts that go to the job growth data. Page 21 refers to a terrific study around four key measures of business. This is my fuel point, this is cap ex—capital expenditure—marketing, training and research and development before and after a private equity buyout. The dark brown bars are after the buyout. That is a study across Europe. There are footnotes and there are notes at the back, and we can provide the underlying studies afterwards if you are interested.

Senator STEPHENS—I would be very interested.

Mr Jones—Okay. Over the page, on the fourth page of section 6, there are studies, again from overseas, around revenue and exports. Again, they show private equity's impact. I will

generalise: these are typically studies over anywhere from three to five years; they are typically around any size samples from 200 to 1,000 companies. They are comparing them to the Stock Exchange pool in those countries, the top 200 or 300 or whatever it is. In Australia we have not got the depth of history yet of larger buyouts, but we did a study last year and Katherine will hit the highlights on the 50 companies that we analysed here.

Dr Woodthorpe—The main issue is that it is the first of a longitudinal study. We recognise that in Australia we do not have the depth of data that, say, the British Venture Capital Association and others have already got in place. We recognise that we need to get on our skates and start producing similar data, so we have done the first of a longitudinal study and the second one is currently underway. The survey is being carried out at the moment with the investees of the private equity companies. This is a snapshot rather than an accumulation of three to five years of data, as the other ones are. Even so, very clear figures came out of it. I think we provided this to you as an appendix to the submission, so you should have the full data in there, but I am happy to—

Senator STEPHENS—Is this the case studies?

Dr Woodthorpe—This is the PricewaterhouseCoopers economic impact.

Senator STEPHENS—Yes, I have got that.

Mr Jones—That is in appendix 4. Also in appendix 4 is an AT Kearney study from Europe, which is sort of an omnibus study trying to collect all of the other studies together. I think that is also attached.

Senator STEPHENS—Yes, we have got that.

Dr Woodthorpe—So we have pulled together quite a range of data, deeper in some cases than in others. And, as I said, we recognise that in Australia this is just the first of many. Even so, they were very clear results, even for just that first snapshot.

Mr Jones—Pretty much all the studies we have seen from overseas are the same story. That is why we are comfortable, but we would be delighted to provide them. I am sure the pagination will not work here either, but in the back there is section 13.3, which is called ‘Reports and studies’. That has all the studies that we have referred to. Their web addresses are not here but they are, I believe, pretty much all referenced on our website.

Dr Woodthorpe—We can certainly provide them in that format.

Senator STEPHENS—Senator Webber asked you if there is any sector of the economy that private equity is not suited to. Can I turn that question around and ask what your experience is in venture capital and innovation and what kinds of trends you are seeing in Australia in investment in those sectors?

Dr Woodthorpe—In venture capital specifically?

Senator STEPHENS—Yes.

Dr Woodthorpe—It has been interesting. Venture capital has, in the last 12 to 18 months, really got underway again. It was going through a bit of a lull, to say the least, but there have been three or four significant funds, or add-on funds, raised in the first half of this year and so I would very comfortably say that venture capital is in a very healthy state at the moment. I think a lot of the lull was around waiting for some returns to come through from the earlier investments going back five and 10 years. Venture capital is a very patient form of investment that takes quite a while to realise, and I think that was why there was a bit of a lag, say, between 2004 and the late part of 2006. But it has certainly risen very strongly in recent times. Venture capital, to use David's analogy of the fuel, the engine and the energy, is driving a lot of innovation in Australia in start-ups, spin-outs and companies that have got so far with the money of friends, family and fools but then really need some serious money to go offshore, to grow their businesses or to go from an R&D, innovation stage of organisation to an organisation that is selling things and making money out of it.

Senator STEPHENS—You have to make sure you capture that phrase.

Dr Woodthorpe—It is a lovely one, isn't it: 'friends, family and fools'?

Mr Jones—Another bit of colour I will add is that, as Katherine touched on, after the dotcom correction of 2000, 2001, 2002, the US market got itself going again at an early stage and we have had a longer period, which is disappointing. Frankly, it is a priority for the association—and it is important for Australia, we genuinely believe—to make sure that that early-stage, innovative end is strong.

I will give you one further piece of colour. The biotech, life sciences side of things has been more robust, and we are quietly hopeful that we are really getting some critical mass there. The IT, technology side—because they are the two main buckets within that sector—is the side that we are most anxious about and still quite focused on, and it is going to be a priority for the association over the coming years.

Dr Woodthorpe—It is fair to say that one of the reasons I was headhunted to the organisation a few months ago is that my background is very much at that innovation end. I sit on an innovation leadership forum group that is chaired by Catherine Livingstone and I worked on a PMSEIC working group about emerging companies, so it is my area of great joy, delight and interest. So it will be something that we are working very strongly in.

Senator STEPHENS—On that point—investing in innovation—who is doing this? Is your membership base a different profile? Is it people who have made their money and now feel there is an opportunity to invest in something that is a bit high risk? Are the people involved in your organisation a different demographic to traditional investors?

Dr Woodthorpe—But, again, they are not retail investors. Whether it is at the venture capital end or the leverage buyout end, it is generally institutional investors in a fund of a superannuation nature or funds gathering together the funds of high net worth individuals to invest. So you cannot compare it with that kind of retail end of investment.

Mr Jones—There is a space they call 'angels', or high net worth. That is typically at the first round of a start-up business plan, and then the institutional private equity comes in after that. There are quite a few different funds focused on that.

Senator STEPHENS—In chapter 10 of your submission about the tax implications you refute the concerns raised by Senator Fielding this morning about the black hole of tax that is being lost to the Australian government and raise some important points about the difficulties of modelling the effect of private equity on the tax revenue.

Mr Jones—Why don't I give you my through line on this point?

CHAIR—While you are doing that, you might want to talk about the protection of the revenue base by way of the thin cap rules.

Mr Jones—Sure.

CHAIR—You might also want to talk about the natural barrier to the excessive debt to equity ratio through the thin cap rules and the lack of deductibility, just in the context of the 99 to one example Senator Joyce gave.

Mr Jones—Sure. The thin capitalisation rules exist, and we know they exist. We are well aware of them and our advisers remind us of them on a regular basis. That 75 per cent threshold exists and we know that it is illegal to claim anything beyond that. As for a particular transaction, the average, as I touched on with Senator Joyce earlier, is 30 per cent equity. There might be a deal—for a toll road or I don't know what—that might be 80 or 85 per cent debt, but you cannot claim that last portion as a tax deduction. It is impossible. It just does not happen, to the best of my knowledge.

Senator JOYCE—Unless you call it a management fee.

Mr Jones—More generally, I understand the argument that a typical public company might have one-third debt and two-thirds equity and, if a private equity firm takes it over, it might have two-thirds debt and one-third equity. There would be more debt and more tax-deductible costs; therefore, that company is not paying so much tax. That is correct. If that incremental debt is all borrowed from an Australian bank, there is no leakage at all to the government because that Australian bank has additional incremental taxable income to exactly the same effect, so it is a wash. But if it is borrowing from overseas through the withholding tax rules, that money does typically go back to the home domicile of the lender and so there is leakage.

Our modelling overlays the other effects, which is all the crystallising effects of running a transaction. The best examples of this are probably Qantas or Coles—if private equity had not got those ones going, probably nothing would have happened. Apart from the earlier comment, the share prices may well have been lower. Each churn in the Qantas or Coles share register crystallises a capital gains tax event; otherwise many shareholders would have left their shares in their bottom drawers. When we tried to model that, we made assumptions that this much of the composition of shareholders was institutional and this was much retail, this much was owned for 10 years and this much was bought last week. We used Price Waterhouse and some of their tax experts have done some modelling for us.

We show that under most scenarios—except for very large deals, most debt is taken locally—it is a wash or, indeed, it is positive. That is before we have tried to overlay stamp duties or any other fees of lawyers, accountants and all the other delightful people we pay. Secondly, there are the secondary effects, which I have touched on in our earlier comments about employment growth and jobs growth. We know that revenue growth drives GST. So, if you believe that we create more jobs and stimulate sales at a faster rate, that is additional increment and we have not modelled that. That is a very long way of saying that that is how we have come to this conclusion: on pretty much all scenarios this incremental debt into a particular company is not really having much of an impact, particularly when you recognise that in three to five years this company is likely to come back to a corporate owner or come back on to the stock market and be—

Senator STEPHENS—Stronger and making more profit.

Mr Jones—a stronger and bigger business, but it will be back in the normal capital structure.

Senator STEPHENS—The committee was provided with a paper from Standard and Poor's that expresses a lot of concern about the avoidance of ratings companies and concerns about levels of subordinated—

Mr Jones—This regards debt packages and the like that do not have covenants attached to them and that have a very low credit rating, like high-yield junk.

Senator STEPHENS—Yes.

Mr Jones—Markets do tend to overshoot; we have known that for a couple of hundred years. I think we have seen recently a modest correction at that very high end. Most people in the market would say that that is not a bad thing—that people are catching their breath and having a proper reassessment of risk. Do we see a systemic issue here that will create some sort of broader contagion? We have seen no indication of that. In any group of transactions, have some been done at the margin? Time will tell, but probably there have been. I think that is what Standard and Poor's is referring to. This is the market at work and people reassessing risk and restructuring transactions accordingly. We actually welcome it. We think it is sensible. This is what flexible markets do.

Senator STEPHENS—Thank you very much. Your evidence has been very useful.

CHAIR—Any deduction for interest paid on debt will always have some revenue implications, will it not, whether it is negative gearing or any other business debt? I assume that the thin cap rules are designed to minimise what is accepted as a loss of revenue under any circumstances. Is that right?

Mr Jones—Yes.

CHAIR—We have heard some fairly wild claims in the media over the last two hours about putting a figure on potential loss of revenue. I would assume that you are able to limit the deductibility of debt through thin capitals.

Mr Jones—Yes.

CHAIR—I presume that, in relation to the revenue debate, you would need to factor in taxation gains from reinvestment of funds, for example. So for a shareholder in a public company, if there has been a buyout, the reinvestment of those funds would need to be taken into account.

Mr Jones—They would need to flow into something else.

CHAIR—I assume that you would also need to take into account potential capital gains tax revenues. Is it reasonable to assume that it is not appropriate to take interest deductions on debt in isolation, when looking at the revenue implications of private equity buyouts?

Mr Jones—Yes, that is our view.

Senator JOYCE—The graph that was presented by the RBA on page 8 shows the debt from foreign owned banks. That debt, just from the pie chart, is well in excess of half the funding. That is far in excess of what current companies in Australia are leveraged by. Those interest payments become income overseas; they are not income in Australia. Is that correct?

Mr Jones—Correct.

Senator JOYCE—There is no doubt that, if I have the capacity to raise billions of dollars, I have the capacity to set up the tax structure to minimise my capital gains tax. I can easily set up a structure that will pay no capital gains tax. I can suggest one now. I could go through New Zealand or some other entity stationed overseas, domiciled overseas, and that would get me out of the capital gains tax as well. That is a fact, isn't it?

Mr Jones—I cannot comment. I know how our fund is structured. I am not sure how other people run their affairs or where they are domiciled, et cetera.

Dr Woodthorpe—On that point, foreigners come and buy assets here and they may or may not raise debt from foreign banks to do so. We do exactly the same. We are part of a global market and we buy assets overseas. I think the RBA this morning pointed out that it was pretty much a net zero sum gain—that we buy as much of them as they buy of us, and we are part of that global marketplace.

CHAIR—Thank you most sincerely for that very interesting presentation.

Proceedings suspended from 3.47 pm to 4.02 pm

CODINA, Mr Martin, Senior Policy Manager, Investment and Financial Services Association

O'SHAUGHNESSY, Mr John, Deputy Chief Executive Officer, Investment and Financial Services Association

CHAIR—Welcome. Mr O'Shaughnessy, I think you have appeared before parliamentary inquiries before?

Mr O'Shaughnessy—Yes, I have.

CHAIR—And you are aware of the usual cautions about parliamentary privilege et cetera?

Mr O'Shaughnessy—I am.

CHAIR—Thank you very much. Mr O'Shaughnessy, would you like to make an opening statement?

Mr O'Shaughnessy—Yes, I would like to. Thank you very much for the invitation extended to IFSA to submit to the inquiry and to attend the committee hearing today. IFSA believes that the committee process is important and timely and will facilitate a more informed debate about the role of private equity investment and the responsibilities surrounding it.

You will note from our submission that we are supportive of private equity investment while recognising that it presents its own set of unique risks and opportunities. Our submission addressed private equity investment issues by first defining the nature of the activity, then looking at the exposure of superannuation funds to that activity, comparing the level of activity in Australia to that overseas as well as to the general level of M&A activity in the economy. The submission then explored the broader impacts of private equity on capital markets and economic efficiency. Finally, we examined the regulatory issues posed, by looking at the fund levels, takeovers, corporate governance and the legal obligations affecting target companies.

I will now briefly turn to each of these main areas—firstly, the size of private equity investment activity. We did not find that the size of private equity investment activity was disproportionate to that occurring in other developed markets. For example, in the 2006 fiscal year, Australia's share of private equity investment in the Asia-Pacific—ex Japan—was around 12 per cent of total funds invested. On a domestic level, the total private equity funds under management in Australia stood at 0.2 per cent of total funds under management over that same period. This equated to 0.19 per cent of the market capitalisation of the ASX. Measured in terms of total mergers and acquisitions, private equity funded M&A activity represents less than one-third of the overall M&A activity in the Australian economy. This is understood to be similar to levels recorded globally.

On superannuation fund exposure: while there is a lack of comprehensive data, it appears that super funds have remained relatively cautious when investing in private equity and have sought to minimise direct exposure to this asset class. According to the Reserve Bank, more than half of

the largest superannuation funds have portfolio allocations to private equity, with the average allocation being around five per cent. Whilst the individual allocation of each fund may be small, it is understood that superannuation funds provide around 50 per cent of private equity funds raised. Having said that, it is important to consider the type of exposure which these funds are likely to have. Our investigations have led us to understand that super fund private equity investments are generally via a 'fund of fund' arrangement. This is especially so for offshore investments.

I turn to impacts—its effect on capital markets and the listed company sector. IFSA believes that private equity imposes a competitive discipline on public market operators, such as the ASX, to the extent that the cost of compliance with market rules as well as listing and other fees remain competitive. Additionally, private equity investment activity provides a comprehensive discipline on the listed company sector as another participant in the market for corporate control. Private equity can also fulfil an important economic role in providing necessary funds for commercial expansion and fill in gaps where other sources of capital are not readily available.

On the regulatory issues: overall, IFSA believes that the current regulatory arrangements that apply to private equity are appropriate. The recent increased interest in private equity has also generated considerable discussion about the regulation of private versus public companies. The general theme which has emerged is that there is a higher regulatory burden imposed on public listed companies compared with private companies and that there is a risk that companies will not list on public exchanges. IFSA suggests that there are very valid reasons why public and private companies are regulated differently. Simply put, one type of company has a large and diverse shareholder base which has very little day-to-day control; whereas the other does not.

It is interesting to note that many private equity transactions eventually involve exchange listings. In a recent survey of nearly 300 private equity companies conducted by PricewaterhouseCoopers, it was found that 53 per cent indicated that they were somewhere in the process of listing or that they planned to list. Indeed, over the last four years, market capitalisation on the ASX has increased 130 per cent, with the number of listed entities increasing by 34.3 per cent over that same period. In this context, it is possible to view private equity as a facilitator for public listings rather than as a threat.

On investment funds related issues: private equity funds offered to retail investors must be registered under a managed investment scheme and regulated under chapter 5C of the Corporations Act. This covers the scheme's governance structure and the responsible entity's duties to investors. Disclosure requirements under chapter 7 of the Corporations Act also apply, ensuring that investors are informed appropriately of the relevant risks, benefits and costs associated with the financial product.

On takeover and corporate governance issues: IFSA members are primarily interested in ensuring that the market for corporate control is both fair and well contested. We therefore support the Takeovers Panel work on insider participation in control transactions. Guidance in this area is a useful addition to the Corps Act and listing rules. Our submission also highlights matters that are likely to concern institutional investors. These include 'late' disclosure of a bid to the market allowing excessive speculation and opportunity for insiders to trade; poorly managed MBO transactions; lack of an ordered and well run auction process to seek out other offers; and director or executive bonuses tied to the successful buyout transaction.

In summary, IFSA is supportive of private equity investment and believes that the current level of activity is consistent with other developed capital and financial markets. IFSA does not believe that there is a strong case to alter the current regulatory arrangements affecting private equity activity and believes that it is an important and necessary element of an advanced and sophisticated capital and financial market.

CHAIR—Thank you, Mr O'Shaughnessy. I will just read from your submission your confirmation that IFSA represents the retail and wholesale superannuation funds management and life insurance industries and has over 140 members who are responsible for investing over $950 billion on behalf of more than 10 million Australians. I just thought it would be useful to have that on the record.

Mr O'Shaugnessy—That is correct.

Senator STEPHENS—Thank you for your submission. You have put a perspective that is slightly different to what we have heard from the regulators—that is, the extent to which compliance measures and pressures have increased over the last five years. Could you, on behalf of your members, expand on your comments about the regulation of public versus private companies and the issue of regulation and what that might force a public company to do?

Mr Codina—We sought to raise that issue by saying that there are differences in the Corporations Act between the legal obligations applying to a public company versus a private company. When I say 'public' I include listed companies, which also have additional rules that they need to comply with. We have sought to go back to first principles and say, 'Why might that be the case?' It is largely about addressing issues of principal and agency between shareholders and the agents that they appoint to manage the company. When you are talking about a public company—or to take the extreme a large listed public company—it is pretty clear that no individual shareholder is going to be able to exercise any real level of control over what those agents do. Therefore, it is very important that we have director's duties and all the other obligations that apply to directors and the requirement that comprehensive financial reports be produced in a timely way to allow investors and shareholders to have a reasonable level of comfort that the company is ultimately being managed in their interests. When you contrast that with the private company scenario—particularly private equity where you have a very concentrated ownership base where often the owners are represented on the board of the private company—you remove a lot of those principal and agent issues which otherwise need to be addressed through these regulatory mechanisms. That is the view that we have taken about why there is a logic to having different levels of regulation. I am particularly talking about the Corporations Act vis-a-vis a public company versus a private company.

Senator STEPHENS—From your perspective, is there a push to create more products that would allow retail investors to directly gain exposure to the private equity sector. Is that something that you are seeing?

Mr O'Shaughnessy—Not really. We have certainly seen a lot more private equity activity and there has been a growth in having it as part of a diversified portfolio, both within superannuation and managed investment schemes. But we do not sense a market push to convert what I would call the bulk, or even a substantial portion, of listed companies into private equity regimes.

Mr Codina—In the early part of our submission we attempt to provide a framework for thinking about how one invests in private equity. At the very front end of private equity investment you are talking about a small number of people making an investment which typically has a lock up period attached to it. These are not the sorts of features that retail investors naturally find attractive. Liquidity is probably something that they would find to be more attractive, rather than those sorts of features. That is why the market, and we know that Australia has a very innovative financial services sector, has probably sought ways of providing access to people who are interested in the sorts of returns that private equity has to offer in a different way—for instance, what we would describe as fund-of-fund type products, which are a way to allow an investor to diversify into a number of private equity funds. Ultimately the underlying investor would not be known to the recipient of the funds to that private equity company. It is really being channelled through a larger vehicle.

Likewise, the quite interesting move to having listed private equity funds is clearly an area where anybody would be open to invest in one of those vehicles. But I just get the feeling that the general characteristics of the way that private equity investment takes place are not all that attractive to a retail investor, unless you package it in these different ways.

Senator STEPHENS—Were you participants in the Takeovers Panel's consultations prior to the development of the guidance note about insider participation in control transactions?

Mr Codina—No. Certainly we were aware that the material was put out for consultation.

Senator STEPHENS—Are you generally engaged by Treasury, the Takeovers Panel or other regulators on those kinds of issues? Is your organisation one that would generally be included in consultation processes like that? It would be, wouldn't it?

Mr Codina—Certainly on issues that we would describe as falling under the corporate governance banner.

Senator STEPHENS—Thank you very much. It was a good submission.

Senator JOYCE—I want to ask a question about parity. Say I am an Australian investor and I want to buy an airline company, and a private equity investor based in another country wants to buy an airline company. Does that person overseas have a strategic advantage over me in how I purchase that asset by reason of tax exemptions that they have that I am not able to get, such as capital gains tax exemptions?

CHAIR—Mr O'Shaughnessy, you are not obligated to answer hypotheticals.

Senator JOYCE—Okay; I will be more direct.

CHAIR—He may be prepared to, but there is no obligation to.

Mr O'Shaughnessy—Thanks. I will not answer the question directly. You will notice that our submission does not deal with the tax issues, either at a national level or at an individual level. In the main, the bulk of this investment sits within superannuation funds, so the nature of the

management responsibility for those funds is over the longer term. We have not studied what I would call the transaction costs, including tax, on a deal by deal basis.

Senator JOYCE—Fair enough. My question was: do you think there would be a better return for the superannuation fund if it was to invest in the Australian company through a vehicle based overseas rather than directly from here? If I wanted to get a better return for my unit, I would say: 'Let's base the unit in New Zealand. We'll invest from New Zealand and get the distributions back through there.' That is surely going to give me a strategic advantage in setting up that facility offshore.

Mr O'Shaughnessy—I am not qualified to answer that question, but again I would say that, from our members' perspectives, when they look at these transactions, they look at the tax impacts over a prolonged period of time. So, in doing their evaluations, they need to take into account, obviously over a prolonged period of time, the profits that the company makes as well as the transaction costs, including the taxation arrangements. I cannot really answer that question specifically.

Senator JOYCE—What is your organisation's view on the transparency of information that you get from private equity firms in making a value judgement on your members as to the probity of their investment? Do you feel that you have sufficient information, and is that information of the same value as it would be in a public company, or do you feel that there is a black hole? What are your views on that?

Mr Codina—I think we are actually talking about a relationship that is much more sophisticated than the one between a retail investor and another kind of investment product, or the way that a retail investor might look at whether or not to invest in a listed company and the sort of information they need. The nature of private equity, if you are thinking about one of our members allocating funds to a particular private equity transaction, means that you would find the level of due diligence that they would undertake to be very high—and it would be quite personal in terms of the kind of engagement that they would have with that private equity fund and the people managing that fund. Ultimately, I would expect them to be across the kind of investments they were looking at making, what the time frames were—as I said, because of the lock-up periods—and the kind of restrictions and other features of that fund or the manager of that fund. They may restrict overall funds—say, no more than 10 per cent to a particular transaction or particular deal. I think you would find that, because of the kind of institutions that you are talking about, which are actually engaged at the end of the investment chain, they would have a very good understanding.

CHAIR—But they are investing in the vehicle and not actually assembling the vehicle, aren't they? Their investment is in the vehicle itself as opposed to putting the vehicle together.

Mr O'Shaughnessy—Sometimes it is both. Sometimes they directly invest. There are two points I would pick up from what Martin was saying. Due diligence is done at a very high level in that area. Their responsibilities are well understood. Sometimes they are directly involved and sometimes they are investing in a vehicle, but on both occasions they are certainly very much aware of what they are investing in.

Senator JOYCE—It is obviously a statement of fact, in terms of investment in private equity, that it would be unwise for a retail investor to walk into a private equity firm because they do not get the access to the due diligence that you get and they do not have that personal relationship. So the asset that is held by the private equity firm is held at the exclusion of the general retail investor because they would have neither the instrument nor the knowledge to make a decision based on the appropriate level of probity.

Mr Codina—Without trying to make the private equity funds sound exclusive, they might not actually want to take any money from retail investors for the very reasons that I described earlier. They do not want people putting money in and then changing their mind in six months time and wanting to take it back out. They are looking for investors who have a track record, who can commit a certain amount of funds and who will go the distance in terms of what that transaction is all about.

Senator JOYCE—In fact it is quite obvious that they can choose who invests and who does not.

Mr Codina—That is correct.

Senator JOYCE—They can work without any question at all with the exclusion of a certain group. They can say: ‘I don’t have to give you a reason; I just don’t want your money. I don’t want you investing.’ Whilst in the share market it is fluid and it changes, private equity allows you to be completely specific. You could say: ‘I don’t want the Smiths to invest in my company. I will take the Joneses.’

Mr O’Shaughnessy—When you look at the service that our members provide, you see that it is basically to give individual investors access to private equity through a disciplined regime. So a retail investor can invest in private equity but it is usually done through a vehicle that runs with the sorts of disciplines that I think you have mentioned.

Senator JOYCE—I have the ability, if I so choose, to actively discriminate against certain groups. It is completely illegal in my capacity to do that. If my private equity firm owns a retailer or whatever then I can say, ‘I don’t really want that type of person investing in it so I’m going to exclude them and let these other people invest.’

Mr Codina—The way I would put it is that private equity funds look at it as taking on a partner and so they are very careful about who they take on.

Senator JOYCE—They should be, too—and they are and will continue to be. Let us say that I am a private equity firm and I undertake my due diligence. Is it your experience—and I am not posing a hypothetical now—that that due diligence is then transposed and reflects caveats in the debt instrument? If I look at the due diligence and I see a threat to my investment there, there and there then I am going to make sure that your access to my funds is conditional on that, that and that and I am going to continually monitor this through a certain range of key performance indicators. That would be a fair analysis of what a person with the appropriate due diligence would construct into a debt instrument, wouldn’t it?

Mr O’Shaughnessy—In part, it is a synopsis. I think their due diligence might be more disciplined and more strenuous than that—

Senator JOYCE—I imagine it is vastly more strenuous and disciplined than that!

Mr O’Shaughnessy—but they certainly do have a very disciplined approach.

Senator JOYCE—I think it would go on for days. What I am saying is: if you want to borrow $1 billion, there is an immense complexity in the debt instrument that you receive. It is not like borrowing money for a house loan, it is not caveat-free; a whole raft of caveats goes with it. It is a very strict, ongoing relationship.

Mr O’Shaughnessy—It depends on the transaction and how much debt is involved in the transaction, but it is a very thorough process.

Mr Codina—I cannot add anything to that.

Senator JOYCE—If I were to, on top of that, structure into my debt instrument a belief of a certain return above and beyond my interests, that would not be unusual? So that if things go well, there is a premium in it for me?

Mr O’Shaughnessy—Again, it will vary with the nature of the transaction—both the debt and the equity interest. In a market, particularly as active as it is in most of the mature economies, there is a contest for capital and a contest for debts. The settings will be in accordance with what the market demands.

Senator JOYCE—Obviously the question I am leading to is: once the caveat becomes intense and there is an upside on a certain profitable outcome, then my debt instrument inherently has all the nature of an equity instrument. The debt becomes a debt instrument in name, but if I get 20 per cent above 20 per cent, I am starting to talk the talk of the equity away from the talk of debt.

Mr O’Shaughnessy—It is beyond our ability to respond.

Senator JOYCE—How do you go about assessing risk in private equity firms? What are the key issues, the key bellringers of risk for you?

Mr O’Shaughnessy—Neither of us are private equity specialists, by the way. The assessment of risk will depend from transaction to transaction, and a lot of it is the length of time you have to leave the money exposed in the transaction.

CHAIR—Mr O’Shaughnessy, if you cannot answer a question, just say, ‘I can’t answer the question’.

Senator JOYCE—Yes. Let us move away from private equity firms. If you are assessing an organisation, how do you assess risk? What are the key issues for risk?

Mr O'Shaughnessy—The risk assessment frameworks are very sophisticated, and that is outside private equity, even in the investment in a public company. They vary from company to company, and they vary against the concerns of the investing institution. I am unable to give you a succinct answer.

Senator JOYCE—I will be more succinct then. In two organisations in exactly the same industry in exactly the same location and at exactly the same time, if one has 75 per cent debt and one has 20 per cent debt, would it be a fair analysis to say there is inherently a far greater risk in the organisation with 75 per cent debt than in the organisation with 20 per cent debt? Or, to be even more succinct, do you think debt reflects an extension of risk?

Mr O'Shaughnessy—I cannot answer the question on the basis that there are many other factors involved and the nature of the debt and the nature of the equity need to be taken into account.

Senator JOYCE—You are saying it is vague. If all other things are the same, the only thing that differs is the debt.

Mr O'Shaughnessy—I am certainly not saying it is vague. To answer your question succinctly: debt and the level of debt would be one of the issues that would be evaluated.

Senator JOYCE—Thank you very much, Mr O'Shaughnessy.

Senator WEBBER—Earlier today we received evidence from the RBA and others about the extent of the private equity market in Australia and comparisons with overseas markets and the fact that the market here is not as mature a market as, perhaps, the US and Europe. Given what you said in your opening statement about the superannuation funds remaining cautious in terms of their exposure, is that likely to change as the market matures?

Mr O'Shaughnessy—I think the level of confidence would influence the amount of a portfolio that is invested in private equity, but that has to be taken in the context of the amount of potential return. We do not envisage dramatic changes in that area and I would say—and I did not hear the evidence this morning—that Australia is not an immature private equity market. In fact, you would have to say that, with regard to sophistication and evaluation, we are benchmarked with most other economies. It is a smaller market, of course.

Senator WEBBER—I think it is also the amount of time the market has been in existence here.

Mr Codina—The only comment I would add is that whether they would increase or decrease their exposures might well be dictated by the performance of some of the asset classes or assets they have invested in. Australian equities, for example, have been going very well, which may in fact have put some downward pressure on needing to source higher returns from elsewhere. So at a theoretical level at least I think that would be something.

Senator WEBBER—Given the flexibility that private equity investment allows as opposed to publicly listed investment, does IFSA have a view in terms of advising its members whether

there is a sector of the economy in which private equity investment is not feasible, is inappropriate?

Mr O'Shaughnessy—We do not give advice as to what the appropriate vehicles are. I would pick up your words 'more flexibility'. I would perhaps turn it around the other way and say that there is probably less flexibility when you get into private equity. You usually have to commit for a period of time.

Senator WEBBER—What I meant by flexibility was not in the exposure but the decision making that happens within that entity because they have surety of finance for three to five years.

Mr O'Shaughnessy—I understand. Martin, do you want to have a go in answering that?

Senator WEBBER—Well passed!

Mr Codina—I don't think that that is something we have really looked at, to be honest.

Mr O'Shaughnessy—We certainly do not give recommendations to our members about their portfolios.

Senator WEBBER—You say that the current regulatory regimes are appropriate. Superannuation companies are obviously a very important economic entity to everyday Australians. After buying our own home, that is about as sophisticated as economic investment becomes for most of us. Is there enough transparency in the investment decisions those funds make for their members in terms of the private equity market?

Mr O'Shaughnessy—We believe so. We have listed in our submission and in my opening statement a number of areas that our members take an active interest in. The view we have is that certainly trustees of superannuation funds and company directors have substantial obligations under Corporations Law, so we are not looking for increased regulation or variance to the regulations that are there. We do believe that we have a marketplace in Australia where the regulation settings are appropriate.

Mr Codina—I do not have anything to add.

Senator WEBBER—The RBA this morning gave us some evidence that it was their view that the private equity market is tightening up a bit with the increased cost of the American mortgage market and what have you. Would that be IFSA's view as well?

Mr O'Shaughnessy—Certainly the media reports on private equity activity have subsided but we would be reading the tea leaves. Do you have any other information, Martin?

Mr Codina—The only comment I would make is that you will find there is always quite a significant divergence between so-called rumours or announcements of possible private equity takeovers or activity and what materialises at the end of the day.

Senator WEBBER—They showed us a very interesting graph that demonstrated that point in terms of this year's activity—for instance, the huge proportion that has been announced but not yet realised.

CHAIR—Given that from a superannuation fund's point of view the private equity asset class is limited—five per cent seems to be the generally accepted number—that in itself would then minimise the risk to members, would it?

Mr O'Shaughnessy—It certainly does. There are often set prescribed limits within the funds themselves. Most managers look at private equity as being a diversification tool, something that they want to have a portion of their portfolio in. By the way, not all superannuation funds have private equity, but many do have private equity, usually running with limits and usually kept to a small private portfolio.

CHAIR—I presume that under the Corporations Act and other vehicles fairly stringent requirements are placed on trustees of super funds in the way they manage the fund itself?

Mr O'Shaughnessy—Most definitely.

CHAIR—I take it from what you have said that the stringency of recording requirements may even be greater than reporting requirements for public companies to shareholders or to the ASX. They are different requirements but their stringency may be even greater than that required for publicly listed companies because of the nature of those investments. Is that correct or incorrect?

Mr O'Shaughnessy—It is very correct. The investors in private equity, as Martin has said and which we have said in our submission, are involved in the transaction. Because they are involved, reporting is often on a daily and weekly basis as opposed to normal market reporting. The other characteristic is that they are investing where there is not a lot of liquidity, so they know that they are in there for some time. I think your statement is very accurate.

CHAIR—Does that provide another layer of protection for members?

Mr O'Shaughnessy—It does.

CHAIR—Thank you for attending today and for your submission. You are excused and we will adjourn these hearings until tomorrow morning in Melbourne. I thank the secretariat and Hansard.

Committee adjourned at 4.38 pm