



Regulating Private Equity

A Re-Define Input for the European Commission

On behalf of the European Parliament

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Background

Private Equity funds have grown at a massive rate especially in the last decade. They are now set for a serious slowdown and retrenchment due to the ongoing financial crisis since leverage, an essential tool of their trade, is very to come by and investors are withdrawing their money in droves. However, many of the issues raised by the growth spurt of private equity funds remain relevant and are some are highlighted below.

Private equity has been growing at a very quick pace and has become highly influential in driving corporate governance.

For example

- Private equity funds' share of global mergers and acquisitions (M&As) increased from 4 per cent in 2001 to 25 per cent in 2006 and to more than 35 per cent in the first half of 2007.
- From January-March 2007, more funds were raised globally by private equity than through public share issues.

The industry claims to help companies focus on the long term by removing pressure to focus excessively on share prices which are no longer listed.

However, Moody's the rating agency finds that "The current environment does not suggest that private equity firms are investing over a longer-term horizon than do public companies despite not being driven by the pressure to publicly report quarterly earnings."

Furthermore a 2007 Moody report states: "We also question whether there is sufficient evidence to prove that the higher returns provided to private equity are driven by stronger management teams or because, in a benign and liquid credit environment, leverage by itself can provide substantial returns to shareholders." This is discussed further in the section on leverage.

More information and transparency

More transparency is one of those apple pie and motherhood things that everyone is for and few people can seriously oppose. However, translating this specifically into policy measures is far from trivial.

Some obvious questions that need to be answered are

- What information?
- To be disclosed to whom?
- And what difference would this make?

It has been suggested for PE firms that the following information needs to be filed in a centralized register available to all regulators

For the management companies

- The name and domicile of the funds they control
- The identity of the managers
- Corporate earnings and bonuses
- Remuneration of directors, senior executives and staff with investment responsibilities
- Relationships with banks

For the investment vehicles

- General investment strategy and any changes to it
- Leverage
- Overall fees and its breakdown
- Source and amount of funds raised
- Past performance
- Risk management systems
- Portfolio valuation methods
- Information on the administrator of the fund
- Share of fund contributed by the management and staff

Some of these pieces of information, such as the basic identity of funds and management etc are absolute minimum requirements and should not be controversial.

The merits of others such as past performance, valuation methods etc are more difficult to assess and are beyond the scope of this brief paper and treated separately.

On the whole, however, increased transparency is a sensible idea provided it is adopted with two caveats: 1) this should not convey the message that investments in PE and HF are any safer 2) transparency alone will not solve the problems highlighted in this paper

Other more relevant disclosures could be

- An earlier disclosure of hedge fund voting interests than is currently the practice – so for example when the share build up is 3% instead of the current 5% level
- This disclosure should include both direct voting interest in terms of an outright ownership of shares as well as indirect interest acquired through derivative transactions as well as the granting of proxy rights etc. The recent controversy of the stealth purchase of VW shares by Porsche highlighted the kinds of problems that can arise from a lack of transparency
- A full disclosure of all related positions – for example, it is common for hedge funds to buy the shares of a company that is likely to be acquired and shell short the shares of the company that is likely to acquire. This means that they have different financial incentives from the shareholders of either the firm being acquired or doing the acquiring and a full disclosure of this interest is essential for good corporate governance and is in the interest of all other shareholders
- This would also help highlight potential and existing conflicts of interests and make the detection and prosecution of insider trading more likely. It has been suggested by the FSA in the UK that as many as a third of all M&A transactions suffer from insider trading, sometimes linked to hedge funds.

- For private equity a disclosure of the financial and other promises being made to the management of the company being taken over should be disclosed so shareholders know whether the management is acting in their interest or its own by backing a private equity takeover.
- More information disclosure on the strategic plans for the acquired company would be important for all stakeholders
- Disclosure equivalent to a public company on issues of societal importance such as the environment, labour practices etc would also be a step in the right direction.
- Disclosure on any dividends, special payments or fees that the private equity firm plans to pay itself would be critical in allowing shareholders and regulators to make up their minds regarding the merit of specific transactions as to whether the motive is asset stripping or not etc

Limiting capital withdrawals from firms after a private equity take over

Warner music was bought for \$1.25 bn in 2003 by a private equity consortium including Bain capital. Within months of being acquired, it made payments including dividends and advisory fees of \$1.43 bn on behalf of its owners.

Just six months after the buyout of Hertz, a trio of private equity companies collected a \$1 bn dividend which was financed by a new loan taken out by Hertz and earned back half their initial equity investment while keeping the amount intact.

The Blackstone group put \$650 million for Celanese, a US chemicals company in 2004 and within nine months had paid itself \$500 million in dividends and an additional \$45 million in advisory fees.

Clearly, this is a serious problem in the private equity industry. Thus putting limits on how much capital can be withdrawn from a firm that has been taken over by private equity makes sense in terms of better aligning the incentives of the private equity firm with a broader stakeholder and societal impact of its takeover of a publicly listed company.

Restricting such front loaded capital withdrawals, in a sense 'locks in' the private equity firm which will have an incentive to manage the firm it owns better as long as it has not recovered its investment already.

It has been suggested that there can be a one year restriction period for such capital payouts which we think is too little. A lock-in period of at least three years or preferably five years, the typical life time of a private equity transaction seems much more appropriate and this ensures that as long as the private equity firm owns the company it has less incentives to asset-strip or jeopardize long term profitability.

Prohibiting pension funds & insurance companies from investing in hedge funds & private equity

It was when the private equity group Blackstone listed a couple of years back that the public first got to know that public and corporate pension funds owned a majority of the private equity firm with a 39% and a 15% stake.

Increasingly, traditional institutional investors including pension funds, insurance firms and mutual funds are putting money into the alternative investment class primarily hedge funds and private equity. Though exact figures are not available, it is likely that almost half of the new investment that has come into HF and PE in the past five years has come from these sources and not high net worth individuals who have been the main investors in these asset classes thus far.

However, because HF and PE is still much smaller than the traditional institutional investors, less than 5% of their investments are in these alternative investment categories though the number for particular funds might be much higher.

So while HF and PE are increasingly dependent on traditional institutional investors, these investors in turn are not overly exposed to HF and PE.

It has been suggested that traditional institutional investors should be 'prohibited' from investing in HF and PE. We think that this is too restrictive. There might be a case for restricting such investments though an outright prohibition might be difficult to justify.

It is impossible to earn a profit in finance without taking risks. There are three main risks open to investors trying to earn a financial return in the markets. These are 1) market risk 2) credit risk 3) liquidity risk

Of these, traditional institutional investors all target taking a market risk by holding a diversified portfolio of assets including shares, bonds and other securities. This makes sense

The other risk that some investors, especially those with a long term horizon such as pension funds and insurance firms (not mutual funds which can be withdrawn at a short notice), should take is liquidity risk. They do this by investing in relatively illiquid assets such as infrastructure financing projects where they earn a return by providing money for a longer term than other investors.

Traditional institutional investors have no expertise or unique advantage in taking credit risk so should leave this to the banks (even though the banks don't seem to be too good at this).

From this perspective how do PE investments look?

PE investments are illiquid – locked in for about five to seven years and earn some liquidity premium especially when the management uses the time frame to improve the efficiency of operation of a company. From this perspective, this is an appropriate investment for institutional investors.

However, at the same time, as we have seen a previous section, private equity firms take concentrated positions in certain companies and this is something that fund managers should not be doing. However, in the context of their overall portfolios which are diversified and the fact that they are usually invested in many PE owned firms at the same time, this may not be that serious a problem.

The bigger problem is that by piling on a lot of leverage, PE firms make the companies they own risky credits. So fund managers investing in PE firms are implicitly taking on credit risk whether they are aware of it or not.

In the end, the decision by a fund to invest in a PE firm or not depends on a trade-off between the higher returns that accrue and the right kind of liquidity risk exposure on the one hand and the wrong kind of credit risk exposure on the other.

Without knowing more details, it is difficult to say whether from a financial point of view pension funds and insurance firms should invest in private equity or not. Mutual funds, which can be redeemed at a short notice, should be forbidden from making PE investments since they are not liquid.

There is probably a good case for restricting the PE exposure of any particular fund to say less than 3% or something of that order.

TBC