Private Equity Funds

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This note describes what Private Equity Funds do, who they are and the conflicting claims as to whether they are a force for good or harm in the world of business.

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A. Introduction

Private equity funds (PEFs) went from being shadowy institutions about whom the general public and mainstream press either knew very little or cared less, to high profile organisations under intense political and media scrutiny, much of it accusatory and negative in tone. If one factor can be ascribed to this turnaround it is a campaign by one of the major trade unions in the UK highlighting what it sees as 'asset stripping' behaviour by such groups. PEFs were initially unprepared for the turnaround in their 'celebrity' status. When they did eventually respond it was with a combination of vigorous defence of past activities and their economic achievements, plus an acknowledgement that certain corporate governance reforms were overdue and the start of an action plan to remedy these perceived weaknesses. This note explains what PEFs are, what they do and explores the argument over whether they are a positive or negative influence in business.

B. Private Equity Funds: what and who are they?

The trade association representing private equity firms is the British Venture Capital Association (BVCA).[1] It lists 198 current members. A recent survey in the *Guardian* listed the following as being the biggest groups in the UK: 3i (one of the longest established groups), Blackstone Group, Goldman Sachs Capital Partners, Terra Firma Capital Partners, Cinven, Advent International plc, JP Morgan Partners, Kohlberg Kravis Roberts & Co, Apax Partners, Candover Investments, Warburg Pincus International and Permira (possibly the most prominent in the current controversy).[2] Some of these groups are stand-alone companies, others are part of banking or insurance groups, such as Goldman Sachs and the Prudential. BVCA produced a detailed guide to what PEFs do and the terms employed in the industry. An edited version is shown below:[3]

> **Definition**
> Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies. Some commentators use the term "private equity" to refer only to the buy-out and buy-in investment sector. Others, in Europe but not the USA, use the term "venture capital" to cover all stages, i.e. synonymous with "private equity". In the USA, "venture capital" refers only to investments in early stage and expanding companies.
>
> **Stages of investment**
> Seed
> To allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commencing large-scale manufacturing. Only a few seed financings are undertaken each year by private equity firms.
>
> Start-up
> To develop the company's products and fund their initial marketing. Companies may be in the process of being set up or may have been trading for a short time, but not have sold their product commercially. Although many start-ups are typically smaller

1 British Private Equity &Venture Capital Association website
2 Guardian, *FSA Warns of Inevitable Crash*, 7 November 2006
3 British Private Equity &Venture Capital Association website

companies, there is an increasing number of multi-million pound start-ups. Around 15% of companies receiving private equity each year are start-ups.

Other early stage

To initiate commercial manufacturing and sales in companies that have completed the product development stage, but may not yet be generating profits. This is a stage that has been attracting an increasing amount of private equity over the past few years, accounting for around 20% of the number of financings each year by BVCA members.

Expansion

To grow and expand an established company. More UK companies at this stage of development receive private equity than any other, generally accounting for around 50% of financings each year by BVCA members.

Management buy-out (MBO)

To enable the current operating management and investors to acquire or to purchase a significant shareholding in the product line or business they manage. MBOs range from the acquisition of relatively small formerly family owned businesses to £100 million plus buy-outs. The amounts concerned tend to be larger than other types of financing, as they involve the acquisition of an entire business. They tend to account for around 15% of financings undertaken each year by BVCA member companies.

Management buy-in (MBI)

To enable a manager or group of managers from outside a company to buy into it.

Secondary purchase

When a private equity firm acquires existing shares in a company from another private equity firm or from another shareholder or shareholders.

Replacement equity

To allow existing non-private equity investors to buy back or redeem part, or all, of another investor's shareholding.

Rescue/turnaround

To finance a company in difficulties or to rescue it from receivership.

Refinancing bank debt

To reduce a company's level of gearing.

Bridge financing

Short-term private equity funding provided to a company generally planning to float within a year.

A more 'colourful' representation of PEFs came in a *Mail on Sunday* article:

> But what exactly is private equity and why has it become such a huge industry? In simple terms, there are three main types of private equity - venture capital, development capital and buyouts.
>
> All three involve the private equity company investing money in return for a stake in a business. Development capital is designed to help develop and expand an established company […]

To put it into context, venture funding could mean an investment of only tens of thousands of pounds while a large buyout could involve billions.

[…]

John Cole, a partner at accountancy giant Ernst & Young, says that the way these firms operate is like buying a house, taking on a mortgage for it and 'then replacing the avocado bathroom suite and putting in Philippe Starck taps and paying professional builders to do the job. 'The increase in value does not go to the bank, but into the owner's pocket.' In this case, the 'professional builders' are often new management brought in by the private equity firms to run the company they have bought.

This is how they aim to maximise their returns during their time of ownership, typically three to five years. The other method they use lies in paying for the company, which often involves a mix of equity and debt. On the equity side, firms have a pool of investors called limited partners, who may range from small investors or wealthy families to major global pension funds such as Standard Life.

They typically commit themselves to a set period, such as ten years, and get their money back when the company in which the private equity firm has invested is sold. This is called an 'exit'. The Centre for Management Buyouts says that private equity firms exited companies to the value of £2.2 billion last year.[4]

C. Government support?

The Treasury has taken a great interest in the City and is keen on promoting its role. This is partly due to reports that the City and financial services generally provide huge tax revenues for the government. The *Guardian* reported recent findings by a consultancy (International Financial Services, London) that financial services account for 8.5% of the UK economy, a quarter of all corporation tax revenue and 12% of all income tax receipts, three times their 4% share of the overall workforce by number. [5]

A recent wpq gave evidence of Government support for the sector:

> The UK's private equity and venture capital industry is the largest in Europe, and the second largest in the world after the United States. The Government have delivered macro-economic stability that allows investors in venture capital to invest with confidence, and a low-tax environment, including an effective Capital Gains Tax rate of 10 per cent. on business assets held for at least two years, which allows them to keep more of the reward from successful investments. The Government also make a number of direct interventions in the venture capital markets to support finance-raising by small companies affected by the equity gap, including Regional Venture Capital Funds and Venture Capital Trusts and the Enterprise Investment Scheme. A new model of support, Enterprise Capital Funds, will soon be launched by the Small Business Service, which will partner public and private money to invest in small businesses seeking venture capital.[6]

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[4] Mail on Sunday, *The Bounty Hunters* 8th October 2006

[5] *Success in the City powers Britain's boom*: 26th September 2006, the Guardian

[6] HC Deb 14 June 2005 c*350w*

Back in April 2003 the Treasury published *'Bridging the Gap',* a study of the failings of finance for, particularly, small firms. Governments have been publishing reports of this type since, at least, the early 1970s when the Bolton Report *Small Firms* was published.[7] In December 2003, the Treasury published its conclusions:[8]

> **6** The UK private equity industry is the largest and most developed in Europe, accounting for over a third of total European private equity investment in 2002. Growth of the UK market has been accompanied by an increasing concentration on larger investments in well-established businesses, for example to finance management buy-out (MBO) activities. These investments make an important contribution to UK productivity and output growth. However, structural features of the market result in an ongoing shortage of venture capital funds to support smaller-scale investments, creating a barrier to business formation and growth.
>
> **E7** Individual investors, including friends, family and business angels, are an alternative source of capital, but are limited by the extent of their personal wealth. This leaves an equity gap for investments that are beyond the financial means of most informal investors, but too small to attract venture capital funding. The gap appears to be most acute for investments between £250,000 and £1 million, but is also severe for businesses seeking up to £2 million – and, for some businesses, it may extend even higher. This equity gap is a barrier to productivity growth, as it can stifle the development of innovative start-up and early-stage businesses, and can constrain the supply of capital for some established businesses that are seeking to modernise or diversify their activities.
>
> **E8** Alongside these constraints on the supply of finance, it is equally important to consider the factors that limit demand. Not all SMEs [small and medium enterprises] are fully aware of the various financing options available to them, and many lack the skills needed to develop a business proposal to a stage where it is ready to attract external investors. There is also evidence that, for some entrepreneurs, the fear of losing control and management freedom is a significant deterrent to seeking equity finance.
>
> **EXISTING MEASURES TO BRIDGE THE FINANCE GAP**
>
> **E9** The Government is already taking targeted action to help commercial investors to increase their activity within the finance gap, and is working with various partners to help enable businesses to identify and attract finance from appropriate external sources.
>
> **E10** The Small Firms Loan Guarantee (SFLG), operated in partnership between government and 23 lending institutions, plays an important role in enabling loans to be made to SMEs that are unable to offer collateral. In April 2003, the Government introduced a package of measures to enhance SFLG, leading to a 40 per cent increase in take-up of the scheme.
>
> **E11** Respondents to the consultation welcomed these changes, and suggested some further potential enhancements to the scheme. In the light of these suggestions, the Government will:
>
> • seek to raise awareness and understanding of SFLG among SMEs and their advisors, by improving the clarity and availability of guidance;

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[7] Cmnd 4811

[8] HM Treasury; *Bridging the finance gap: next steps in improving access to growth capital for small businesses*

- continue to work with partner lenders to encourage consistent application of SFLG, for example by simplifying the administrative requirements of the scheme wherever possible;
- publish details of how new lenders wishing to participate in SFLG can apply to do so; and
- undertake a review of SFLG to ensure that, in the light of changing debt market conditions, the Government continues effectively to help small businesses to overcome barriers to raising debt finance.

E12 Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) offer a number of tax reliefs to encourage private investors to invest in small companies affected by the equity gap, either indirectly through a mediated fund (a VCT) or by investing directly in the small company (through EIS).

E13 The Government is mindful of the recent relative weakness in the VCT market, and is in favour of providing a less cyclically-sensitive set of incentives for investors. To help relieve the cyclicality of fundraising, the Government will consider withdrawing, from 6 April 2004, the ability to defer liability for capital gains tax (CGT) by investing in VCT shares. It proposes that, in the long term, the incentive effect of withdrawing CGT relief should be offset by an enhancement, of equivalent value, to the level of income tax relief for new subscriptions to VCT shares. To provide a boost to fundraising, the Government proposes to increase the upper limit for eligibility for income tax relief from £100,000 to £200,000 in any single tax year.

E14 In the short term, and subject to consultation, the Government intends to provide a stimulus to VCT fundraising through an additional temporary improvement to income tax relief for a period of two years from 6 April 2004. The Government will discuss with business the most appropriate form for this temporary improvement to take, but its favoured option is to increase the effective rate of income tax relief from 20 per cent to 40 per cent, with the additional relief paid directly into the VCT for investment in companies seeking finance.

E15 The level of investment through EIS has held up relatively well. The Government will therefore continue to assess options for incremental changes to improve the commercial operation of the scheme, drawing on suggestions made in response to the consultation. In line with the proposed increase in the upper investment limit for VCTs, the Government proposes to increase the upper limit for eligibility for 20 per cent income tax relief through EIS from £150,000 to £200,000 in any single tax year, with effect from 6 April 2004.

E16 The Government is taking forward a series of measures to help ensure that these supply-side measures are backed by more effective demand for growth capital from SMEs. These measures will include:

- working with Regional Development Agencies to build on the findings of the recent 'investment readiness' demonstration projects at the local level;
- with the accountancy profession and other business bodies, developing the proposals of the Accountancy Working Group, which has been considering how best to enhance the role of business advisors in providing financial advice to firms;
- launching a *no-nonsense guide* to finance for SMEs; and
- asking the Small Business Investment Taskforce to examine the scope for a review of demand-related issues, looking in particular at barriers to the growth of affordable financial intermediation focused on small-scale equity finance.

E17 Notwithstanding the contribution of existing measures, most respondents to the *Bridging the finance gap* consultation believed that a small but important minority of growth companies will continue to be constrained by the equity gap. Respondents supported the objectives put forward for a new approach based on the US SBIC programme, and suggested ways in which the model could be adapted to maximise its impact in the UK market.

> **E18** The Government therefore believes that a suitably designed variant of the SBIC programme could play an important role in supporting increased private-sector investment in the equity gap. It recognises that the design of such a programme would need to take full account of the differences between the US and UK markets, and the lessons that have been learned from the 45-year history of the US programme.
>
> **E19** The Government therefore intends to explore further the scope for such a programme, by:
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> - inviting bids for a round of 'pathfinder' funds based on the SBIC model, to be known as Enterprise Capital Funds (ECFs); and
> - using the lessons learned in establishing the pathfinder round to determine whether and how to develop a longer-term ECF programme.
>
> **E20** The Government intends to allocate leverage to pathfinder ECFs through a competitive bidding process and, subject to receiving the necessary European state aids clearance, will publish detailed bidding guidance in spring 2004. In the pathfinder round, prospective ECF managers will be allowed some flexibility to specify in their bids how the proceeds of their successful investments would be allocated between private investors and the Government. This will allow more equal risk-sharing between the Government and private investors, compared with the model proposed in the consultation paper. The Government is seeking state aids clearance on the basis that pathfinder ECFs would be allowed to invest in financing rounds of up to £2 million, with additional flexibility for follow on rounds.
>
> **E21** The Government believes that, should it decide to proceed with a longer-term ECF programme, this would most effectively be delivered through a company set up specifically for that purpose. Such a company would operate at arm's length from government, and would be given the operational freedom needed to adapt its approach in the light of its experience and in response to changes in the market for SME finance.[9]

Setting up the 'Business Angel' ECFs was not without its problems. Principally, participants were wary of having to be fully regulated by the FSA if they set up one of these funds. The upshot was that the Government published an order adding BA –ECFs to the list of exempt activities under the Financial Services and Markets Act.[10] The accompanying explanatory memorandum included the following:

> 7.3 *Bridging the finance gap* therefore announced the Government's intention to launch a 'pathfinder' round of ECFs. ECFs will be commercially-managed funds, established to invest a mix of public and private sector capital in SMEs with growth potential that are affected by the equity gap. The pathfinder round would test the scope for a long-term ECF program which would aim to stimulate an increased flow of private capital into the equity gap, and to lower the barriers to entry for potential new participants in this part of the risk capital market.
>
> 7.4 Business angels are an important source of equity finance for SMEs and as such, play an important role in addressing the equity gap. Broad estimates suggest they provide between £500 million and £1 billion of investment per annum in around 3,000 to 6,000 businesses. Whereas structured business angel syndicates have been a

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[9] HMT *Bridging the finance gap: next steps in improving access to growth capital for small businesses*

[10] *Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No 2) Order 2005* (SI 2005 No. 1518)

> significant feature of the US enterprise economy, there are currently relatively few groups operating in the UK. The Government believes that structured syndicates have a potentially important role to play in the UK, enabling greater total sums of investment into individual firms.
>
> 7.5 ECFs offer a potential mechanism for groups of high net worth and sophisticated investors to take the first steps towards formalising existing loose networks and benefit from government support to leverage their impact in the private equity market. One of the objectives of the ECF pathfinder round is to test the appetite for ECFs amongst business angel groups (who would actively invest their own funds, but not the funds of other passive private-sector investors), as well as amongst fund management professionals.
>
> 7.6 However, the Government is aware that the costs of regulatory compliance may present a barrier for groups of angels who are contemplating submitting bids for pathfinder ECFs. The Government therefore consulted on proposals to allow the operator of a BA-led ECF, under certain circumstances, to operate that fund without the need for authorisation by the FSA under the Financial Services and Markets Act 2000 (FSMA) and the Regulated Activities Order.[11]

This support was reiterated in a speech by the Economic Secretary, Ed Balls, in March 2007 at the London Business School. He said:

> Private equity, like any other form of ownership, has good and bad aspects - and it has features of both long-termism and short-termism. But the evidence does not suggest that Government has any intrinsic reason either to "favour" private equity or to do the opposite.
>
> Our aim should be to support economic dynamism and long-term investment and job creation. And the Government's objectives in the field of private equity should be no different from its objectives in relation to any other form of ownership: to promote an environment of long-term, sustainable business success, underpinned by a strong culture of clear disclosure to, and engagement with, underlying investors. This is the way to ensure that "good" long-term investment propositions prosper.
>
> One potential advantage of private equity is that the long and complex chain of ownership and communication does not exist, giving the owners of capital much clearer direction of the businesses which they are financing. The shorter chain, the clearer targets and accountabilities, and the stronger incentives which can be put in place, all have the potential to provide higher levels of efficiency. These advantages will in some cases outweigh the benefits of public market ownership, such as access to large amounts of long-term risk capital and the ability to attract top management talent, although investors need to be vigilant, too, about any potential for misalignment of incentives within the private equity model. Moreover, it is harder for private equity to do this if it fails to provide the information needed to judge its contribution to a modern economy, or if there is any obscurity in its information flows to its investors.[12]

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11 Explanatory Note

12 HM Treasury website 8 March 2007

D. Regulation deficit?

There has been considerable discussion about the regulation of the sector following the publication in November 2006 of a FSA Discussion Paper *Private Equity: a discussion of risk and regulatory engagement*. The accompanying press release stated:[13]

> The FSA believes that the private equity market is an increasingly important component of international capital markets and makes a key contribution to the efficiency of these markets. However, recent market developments have prompted the FSA to consider whether it currently exercises an appropriate level of regulatory engagement with the sector.
>
> The FSA is seeking feedback from the industry and public policy makers on whether it has correctly identified the risks posed by the growth in the private equity market and the suitability of its regulatory approach in addressing these risks.
>
> Hector Sants, FSA Wholesale Markets and Institutions Managing Director, said:
> "We believe private equity can significantly enhance capital market efficiency by widening the availability of capital, increasing the effectiveness of company valuations, identifying companies with growth potential and facilitating their transformation.
>
> "The growing movement of capital from the public to the private equity market over the last few years poses challenges, not just for the FSA, but for all regulators charged with oversight of international capital markets.
>
> "Too much regulation can be detrimental to capital market efficiency, but too little regulation can damage market confidence. So we are asking industry and policy makers to engage with us in ensuring that the UK maintains an appropriate approach to regulating the private equity industry."
>
> The FSA will establish an alternative investments centre of expertise by integrating private equity firms and supervision staff into the existing hedge fund managers supervision team and will continue its proactive monitoring of institutional leverage and credit markets.
>
> Given the growth in this market the FSA has been increasing its engagement and understanding of the sector, and as part of this work has recently completed a survey on the leveraged loan market which was also used to feed into the recent European Central Bank survey.[14]

The press concentrated on the remarks by FSA Managing Director Hector Sants, to the effect that a collapse of one of the funds was 'inevitable' due to the highly leveraged nature of their financing. However, this is not seen by the FSA as likely to cause systemic problems and the development of regulation does not appear to be in the direction of making them fail-proof. The current regulation of PEFs is somewhat complicated.

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13 Discussion Paper 06/06

14 FSA Press notice 6 November 2006

PEFs are regulated if they are companies listed on the UK stock market. However, most are not, and so they are unregulated, but, the individuals who run the funds (and individuals here could include banks etc) are regulated by the FSA because of the service that they provide i.e. investment advice. Investment advice is a regulated activity under the *Financial Services & Markets Act 2000.* In addition, conduct during a company takeover – for listed companies - is regulated by the City Code, which is administered by the Takeover Panel. The Panel became a statutory body with extra powers of enforcement because of reforms introduced by the *Companies ACT 2006.*

It could be argued that getting the external regulation regime right is even more important for PEFs than it is for other financial service companies. This is because many of the automatic checks and balances that apply to public companies do not apply to private companies that have been taken into private ownership. At one level, for example, there are concerns about the transparency in the way these companies are run. Under the new Companies Act, for example, private companies do not have to have a company secretary – a role that is normally seen as akin to a referee or friendly legal adviser keeping the company up to its legal responsibilities. Furthermore, by virtue of the Companies Act 2006 private companies will not have to prepare a full business review – the non-financial business report- that replaced the fledgling operating and financial review. If, for example, Sainsbury's was bought out by a PEF its business review would, by virtue of Section 417 of the CA 2006 not have to include a report on environmental matters, the company's employees or social and community issues.

E. The campaign against

The issue of PEFs has been brought to media and public attention largely, but not exclusively, by a GMB Union campaign centred on the experience at the motoring organisation the AA. The arguments against, in this case Permira, were set out by a GMB official in a press release in February 2007:

> GMB are calling upon Gordon Brown in his next budget to end tax relief for interest payments on loans used by venture capitalists to buy companies like AA, Birds Eye and Sainsbury's. This relief costs the Exchequer hundreds of millions per annum while giving debt unfair tax advantages over equity. This transfer from taxpayers is now leading to the destruction of household names companies by venture capitalists who are saddling these employers with massive debts.
>
> For example at AA, since the venture capitalists took over in 2004, they have loaded the AA with debts of £1.9 billion. This massive debt amounts to over six years of the subscription income from the AA's individual members. It amounts to £300,000 per AA employee. This debt is backed up by virtually no assets since nearly all buildings and fleet used by AA are leased. At AA the venture capitalists sacked 4,000 of the 10,000 staff saving £100m per annum on resources devoted to dealing with 4 million breakdowns a year
>
> Not surprisingly services to AA customers have declined. AA response times have fallen from first to third in the Which rankings. As there are fewer patrol staff to deal with same volume of breakdowns each patrol is forced to work overtime and has to attend a higher number of breakdowns per day. The patrols are only able to provide a lower level of roadside service particularly to the 4 million individual

AA members. More of them end up being towed to garages than was formerly the case.

Profits at AA have risen to £175 million of which more than half is used to pay interest on the £1.9 billion loans. So rather than the Exchequer receiving tax on these profits the Venture Capitalists are able to claim millions in tax relief on the interest payments. Thus the taxpayer is subsidising the activities of the venture capitalists.
GMB MPs are seeking an adjournment debate later this month to press this policy on the Chancellor. The news that these same venture capitalists are circling Sainsbury's makes this change of policy more urgent."[15]

This statement was backed up by a speech by the General Secretary of the TUC, Brendan Barber, later in the same month:

In the strongest comments yet by any trade unionist or Labour party politician, Brendan Barber, the TUC general secretary, said he would warn pension fund trustees controlling £300bn of assets to think hard before investing in private equity schemes.

He promised to urge ministers to regulate an industry "that at the moment is pretty much allowed to operate with impunity".

[…]

Mr Barber said that, while private equity had sometimes turned round ailing companies, operators sometimes gave the impression "of being little more than amoral asset-strippers after a quick buck; casino capitalists enjoying huge personal windfalls from deals at the same time as they gamble with other people's futures."

"The problem is simple: private equity can steer clear of the responsibilities a public company has to live up to. Its owners will disclose as little as possible about what they are doing, and why. In companies that are often leveraged to the hilt, it's employees who end up shouldering much of the risk, with downward pressure on pay, pensions and job security."[16]

A more general criticism of the trend came from the UN, concerned about development issues:

THE United Nations has issued a controversial warning about the economic and social dangers facing countries where private equity funds take over a local company. It came after it found that a fifth of all major cross-border deals are now being masterminded by hedge funds and private equity groups.

The discovery underlines that these secretive investors are now responsible for a major slice of international investment and are an increasingly important component of the world economy. Research from the UN Commission for Trade and Development (UNCTAD) found that private equity groups and hedge funds spent $135bn (pounds 72bn) on cross-border mergers last year - 19pc of total activity.

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[15] GMB website 5 February 2007,
[16] *TUC chief attacks private equity industry* Financial Times, 21 February 2007

While it acknowledged that these kind of investors were now extremely important for the flow of capital around the world, it added that it had doubts over whether this particular type of investment was always beneficial for the recipient country. "The increasing activity of private equity funds in cross-border investments raises questions about the implications of such investments for the long-term growth and welfare of the host economies," it said. It pointed towards the fact that unlike other kinds of FDI [foreign direct investment], private equity firms tended not to undertake long-term investments and quit in five to 10 years. [17]

In the United States, there have been regulatory concerns over the share prices paid for companies as the *Financial Times* Reports:

The US Department of Justice has launched an inquiry into whether private equity firms collude with each other to hold down the prices they pay for companies they acquire. Do not expect Henry Kravis of KKR or Steve Schwarzman of Blackstone to be led away in handcuffs any time soon. They are too alert to the perils of breaching anti-trust law and employ too many lawyers to engage in overt conspiracies. Whether there is tacit collusion, or a culture of trying to avoid bidding wars, is another matter. Mr Kravis led the most notorious of leveraged buy-outs - the $25bn acquisition of RJR Nabisco in 1988. KKR was forced to pay double RJR's original valuation in a fiercely contested auction, made a poor return on investment and its partners became known as the Barbarians at the Gate.

[…]

Those funds believe there is an "obvious cause" - or several - for their great wealth. The big companies they buy are of better quality, on average, than the mid-market ones that smaller funds acquire. They can attract better executives to run them. Banks will lend them money on finer terms because of the fees that big transactions bring. The funds bring more expertise to the task.

The elite buy-out funds view themselves as akin to Silicon Valley venture capital funds such as Benchmark Capital and Sequoia Capital. They invest with each other both to diversify risk and to benefit from a keiretsu effect. Each fund puts a director on the board of the acquired company and pushes business its way from other companies it owns. Such charmed circles may irritate outsiders but are perfectly legal.

No matter how expert and influential a private equity fund is, however, the price it pays to acquire stakes in companies matters a great deal. So it helps when an auction for a company draws out only one or two bids, or there is no auction. By forming consortia and locking up finance from the biggest Wall Street banks, private equity funds reduce their chances of being forced to bid fiercely against each other.

A lot depends on the behaviour of the company that is selling itself, or one of its divisions. Its directors can do a number of things to keep things lively. It can insist that debt financing is available to all bidders and impose strict confidentiality requirements preventing (at least in theory) collusion over bids. It can arrange consortia of bidders itself once it has received expressions of interest.

[17] *UN warning over role of hedge funds* , Daily Telegraph, 17 October 2006

> Things often get murkier when the management of a company itself gets involved in a bid. That provides more of an opportunity for buy-out funds backing the executives to avoid an auction. The company's directors may be too slow to avoid a chief executive gaining an unfair advantage for his or her bidding consortium, or other funds may decide the company is not worth acquiring without its managers. [18]

The two main planks of criticism therefore are that PEFs are run on profit maximising but short run time scales that do not support investment, employment or performance in the long run. Secondly, that they impose a public revenue cost as they enjoy favourable tax treatment.

Anecdotal evidence of the first complaint has been channelled by the union campaign that started the current controversy. Much of this centres on the treatment of staff at the AA motoring organisation that was bought by CVC Capital Partners and Permira in July 2004. A *Guardian* article highlights some of the claims:

> When it first changed hands, the AA employed about 10,000 people, but in the wake of the buy-out, employee numbers were reported to have been cut by 3,400. A new staff organisation supplanted the once-dominant GMB trade union, which the management de- recognised. Allegations began circulating about the AA pressurising staff into accepting severance packages, and targeting some of its most vulnerable employees, including 13 who were classed as having disabilities.

[…]

> "My morale is at the lowest it's been in the 15 years that I've worked for the AA," one patrolman tells me. "Most of the discussions that I have with my colleagues will start off on the basis of, 'This job is turning worse by the day, isn't it?'" Another sounds no less gloomy: "It's terrible. They're just not looking after AA members. But it's nothing to do with members any more - it's to do with the figures and targets, which are just too high. I have to complete around eight jobs a day now, which is just impossible."
>
> The company is prone to dismiss such talk as part of the GMB's vitriolic campaigning. The AA acknowledges that about 3,000 staff have exited the organisation, but press spokesman Gavin Hill-Smith claims that most of that number worked for "niche businesses" of little relevance to the membership. He says that 500 patrol staff have been lost - 17% of the old total - and that this was the result of a "performance review process" that weeded out "a small minority of patrols that weren't doing the job to the required standard". Most of those who parted with the AA, he says, "voluntarily chose to leave the company".
>
> The new increased targets, he insists, are achievable, and morale does not seem to be a cause for concern. When I tell him about several off-the-record conversations with very dejected patrol staff, he says, "There'll always be people in an organisation who aren't 100% happy, but I don't think it's fair to tarnish the whole of the patrol-force with the views of three or four individuals."
>
> But even a chat with an apparently off-message patrolman - one the union presses me not to talk to - eventually paints much the same picture. At first, he sounds a little more positive than some of his more hard-bitten colleagues. "I like the job," he says. "I do. I enjoy it. But it used to be built very much on trust, whereas now it's built on paranoia. Like the fact that I've asked you to phone me on my non-work phone - we

[18] *The case for barbarity in private equity.* Financial Times 15 October 2006

> know that they're listening to our calls now. They've told us that they do that. In every activity we do, we're watched.
>
> "Prior to the takeover," he says, "targets were never an issue, unless you were slacking. They were something in the background. Now, they're the be-all and end-all of working life. I've got colleagues I know who are perfectly good patrolmen - if one of my family broke down, I couldn't wish for anybody better to go and see them. But they've been in the situation where they're fearing what their figures say, for jobs per shift and that sort of thing. So we're all on a bit of a nervy edge. That's how it feels, day to day."
>
> Most damningly, he says that the new culture of target-worship and trigger-happy management (his area, he says, was once covered by "several" patrols, whereas now there are just two) is threatening to have serious, unintended consequences. "A lot of compromises seem to creep in," he says. "At one time, 'safety first' was paramount. There were no questions if you had any doubts about safety. These days, it seems to be pushed away a little bit." [19]

Academic evidence for the long-term impact of PEFs is still in its early stage, however, a provisional, yet to be finalised, working paper from the University of Nottingham provides some of the latest evidence.

The paper, *The Impact of private equity setting the record straight*, by Wright, Jensen, Cumming and Siegel, summarises more detailed work and includes the observations that:

> Evidence of the magnitude and the sources of the expected shareholder gains in U.K. public to private transactions in the second wave of buyouts from 1997-2003 shows that, on average, pre-transaction shareholders reap a premium of approximately 40%. The chief sources of shareholder wealth gains appear to be undervaluation of the pre-transaction target firm and incentive realignment through enhanced equity ownership for managers.

[…]

> During the twenty-year period 1985-2005 in the UK, there were 12,267 U.K. buyouts, of which 1,431, or about 12%, had entered receivership by the end of 2005. Our evidence indicates that of the buyouts that default, secured creditors recover on average 62% of their investment, and many of the companies are eventually restructured and sold as going concerns.
>
> Apart from returns to investors, other evidence on buyout performance has focused on accounting measures of the firm itself. U.K. firms experiencing an MBO have been found to generate significantly higher increases in return on assets than comparable firms that did not experience an MBO over a period from two to five years after buyout. There is also evidence that buyouts that return to the stock market backed by more active private equity firms perform better than those backed by less active private equity firms.

[…]

> Our final sample consisted of 979 firms, which covered 4,877 plants that had been subject to an MBO. We compared these firms with a sample of 36,000 non-MBO plants. We found that MBO plants were significantly less productive than comparable plants before the transfer of ownership but they experienced a substantial increase in

[19] *In need of assistance?* The Guardian, 2 March 2007

total factor productivity (i.e. assets and labour) after a buyout of up to 90%. The results imply that the improvement in economic performance is at least partially due to measures undertaken by new owners or managers to reduce the labour intensity of production, through the outsourcing of intermediate goods and materials.

[…]

Related evidence from the UK also shows that employees in MBO [management buy-out] firms have more discretion over their work practices than comparable workers at non-MBO firms. But it is important to distinguish between private equity deals driven by insiders and those driven by outsiders. Evidence from 1,350 U.K. buyouts observed over the period 1999-2004, shows that employment in the MBOs dips initially after the buyout but then begins to rises above pre-buyout levels, being 21.4% higher on average by the fourth year after the buy-out compared to the year before buy-out (Table 2). In contrast, for MBIs, [i.e. PEF and similar deals] there is a greater dip in employment level immediately after the deal with the level remaining below the pre-buy-out level, on average being 3.3% below the pre-buy-out level by fourth year afterwards. It is important to bear in mind that it cannot be assumed that the pre-buyout employment levels would have been sustainable. Even here it cannot be assumed that the pre-buyout employment levels would have been sustainable. Profit per employee has a positive effect on wage growth, suggesting that employees' wages grow when profits grow.

The overall picture from these large-scale studies across different methodologies, measures and time periods is that private equity deals, especially MBOs, enhance performance and have a salient effect on work practices. However, the private equity market does face a number of key challenges.

The development of auctions for private equity deals and the stronger emphasis on shareholder value by corporations in recent years as corporate governance has become more active, may make it more difficult to generate the financial returns realized by MBOs during the 1980s in today's environment through financial engineering alone. Even so, it is difficult to believe that there is no fat left in the system to be taken out. There may be less, but there are still likely to be opportunities or improved efficiencies, especially in continental Europe.

While some private equity funds are persistently good performers, not all are. Growth of funds and new entrants into the market with limited expertise in doing private equity deals or in doing private equity in a particular context, such as continental Europe, suggest that although there are gains to be made, many firms will not make them.. Some funds are naive and those will generally be the new ones or learners. This suggests a shift to buyouts involving businesses where managers who identify entrepreneurial opportunities for new products and markets become frustrated with a bureaucratic corporate structure where proposals for new ventures are rejected by corporate management because of the lack of hard information that fits into organization-level investment appraisal systems. Evidence from the U.S., U.K. and the Netherlands, shows that buyouts are followed by significant increases in new product development and other aspects of corporate entrepreneurship. For private equity firms to play an important role in supporting entrepreneurial buyouts they must hire executives with greater product market and strategic expertise to assess the investment initially and to monitor it subsequently. Lower levels of debt are generally necessary to enable the buyout firm to implement identified opportunities for strategic innovation.

Secondary buyouts account for a large proportion of the value of the U.K. market and they are also increasingly common across Europe. Third and fourth-time around buyouts are also becoming more in evidence. The changes in ownership and

> financing that occur each time may be a means of enabling buyouts to become a new long term organizational form. However, such sequential buyouts raise challenging issues relating to performance evaluation. In particular, if the original private equity financiers were effective, how likely is it that further performance gains can be achieved? For the incoming investors, an important issue is will managers be buyers or sellers in the deal and what will be the impact on performance? Further, when management increases its equity stake, there may be a corresponding reduction in control by the private equity firm. This may result in management embarking on risky growth strategies with little monitoring. Initial evidence is that returns to exiting through secondary buyout are lower than for flotations and sales to corporate buyers.

[…]

> The buyout and private equity market has now been active for over a quarter of a century and has shown remarkable resilience and adaptability in that time. The buyout and private equity market played a significant role in enhancing the competitiveness of U.S. business. Yet, it is worth recalling that the kind of concerns now being expressed in the U.K. and across continental Europe were also evident in the early days of the market in the U.S.

One of the main planks of the criticism of PEFs is that the significant debt costs (interest payments) that PEF spin off companies are left with as a typical consequence of their purchase and sale, are tax deductible and hence 'subsidised'. Three points are worth making here. First, generally speaking interest payments are tax deductible for all companies. Secondly, any changes to tax rules in order to target PEFs are liable to target a very much greater number of companies than the 200 or so. Lastly, some changes to interest payment deductions are already in the pipeline. An article from the *Financial Times* explains the complexities:

> From next month, tax bills of private equity-backed companies are set to rise by tens of millions of pounds a year after rules restricting tax relief on interest payments are implemented fully. But industry experts expect the extra revenues will be smaller than anticipated by Revenue & Customs when it announced the phased introduction of the new rules two years ago.
>
> […]
>
> The regime brings private equity debt within the scope of "transfer pricing" legislation, which limits the tax relief given to heavily borrowed companies. These limits are based on the maximum debt that an independent third party lender would be willing to provide.
>
> Changes in the debt markets and the banks' appetite for risk have reduced the impact of these rules because it has become easier for a company to show an independent lender was prepared to make large loans.
>
> The complex ownership structure of private equity investments meant that until March 2005, very few private equity-backed companies were subject to transfer pricing rules. Anton Hume of BDO Stoy Hayward says that before March 2005 many such companies paid little tax since the level of interest deductions on bank debt and shareholder debt tended to swamp their tax-able profits. All deals agreed or refinanced since March 2005 are already subject to the new constraints.
>
> Calls by unions and some Labour backbenchers for the scrapping of tax relief on interest costs incurred by private equity-backed businesses have so far been rebuffed by the Treasury. Even though there is widespread opposition to wholesale reform of

the rules allowing interest costs to be deducted against tax, some industrialists and tax specialists believe there is scope for further tightening of the tax treatment of interest for highly geared companies.

> Although the Treasury is unlikely to consider further reforms soon, some experts think it will come under pressure to fall in line with other jurisdictions that have more prescriptive rules.
>
> In France, Germany, the Netherlands, Spain, the US and Japan, the tax authority decides how much interest is deductible by reference to an explicit debt to equity ratio. The US also limits the deductibility of interest in certain circumstances where the interest income is not subject to US taxation. Chris Sanger of Ernst & Young warned against a limit for interest deductibility. He said it would be unfair because everyone had the option to use debt and it could hit companies that were highly geared because of trading problems. [20]

However, in the speech to the London Business School, Ed Balls, announced a review of how debt, where it replaces shareholder equity is to be treated for tax purposes. He said:

> However, concerns have been raised with the Treasury that something further may in some cases be occurring - in particular, that 'shareholder debt' is replacing the equity element in highly leveraged private equity funding arrangements. This shareholder debt is a form of risk-bearing equity that is treated as debt for tax purposes, giving these arrangements a tax advantage that is inconsistent with the principle that interest is a business expense. Tax legislation already distinguishes between debt and equity and contains detailed provisions to ensure that equity is not disguised as debt to obtain a tax deduction. Rules have changed from time to time over many years to adapt to the development of new financial instruments and forms of debt, most recently changes in 2005 to enable the transfer pricing rules to be applied more readily to the issue of shareholder debt.
>
> 79. Today, I can announce that the Government will review the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals in the light of market developments, to ensure that existing rules are working as intended and report back by the Pre-Budget Report. This is consistent with the Government's focus on ensuring that commercial decisions are taken on a level playing field, take a long-term view and maximise opportunities for employment and investment.[21]

F. The industry's response

It is fair to say that the BVCA is working in a considerably more critical environment than it might have expected a year ago. The reaction of the industry has been, principally, twofold: highlight the positive work of the industry and produce its own responses to some of the immediate criticism. An example of the former came in the Association's 2006 Pre Budget Briefing.[22] The introduction to this Report is shown below:

[20] *Clampdown on private equity may yield little* Financial Times 1 March 2007

[21] op cit

[22] Report of submission found here FT, 30 October 2006

2. The impact of the private equity industry on the UK economy

The provisional findings of the eighth report reinforces those in the previous surveys commissioned by the BVCA. Private equity-backed companies are a significant driver in the UK economy and its global competitiveness. Private equity-backed companies create jobs at a considerably faster rate than other private sector companies. Over the five years to 2005/6, the number of people employed worldwide by UK private equity-backed companies increased by an average of 9% p.a. This compares dramatically with FTSE 100 and FTSE Mid-250 companies, at 1% p.a. and 2% p.a. respectively. Furthermore, around three-quarters of companies said their growth was organic, rather than by acquisition, since they had private equity backing.
[...]

Over the five years to 2005/6, on average private equity-backed companies' sales rose by 9% p.a., compared with FTSE 100 companies (7% p.a.) and FTSE Mid-250 companies (5% p.a.). Exports grew by 6% p.a., compared with a national growth rate of just 2.2% and investment rose by 18% p.a., compared with 1.1% nationally. 92% of responding companies said that without private equity the business would not have existed at all or would have developed less rapidly. Private equity investment is more than just the provision of capital. Around two-thirds of respondents identified strategic direction, financial advice and help with contacts as being key ways in which private equity firms had helped with the development of their businesses.

Half the firms said that their level of investment was higher as a result of private equity backing. It is estimated that companies which have been private equity backed generated total sales of £424 billion, exports of £48bn and contributed over £26 billion in taxes.

3. The impact of the private equity industry as a UK financial service

In addition to our increasing impact on the economy as a whole the UK industry has a specific and positive impact as one of the UK's leading financial services. For the first time this year we have commissioned research to examine this impact in detail.

During 2005 private equity related activities generated estimated fee revenue for financial and professional services firms of over £3.3bn, representing around 7% of the total annual turnover of the UK financial services industry. There are more than 5,500 individuals employed across 267 private equity, venture capital, funds-of-funds and secondary investment firms in the UK.

[...]

Almost 30% of all UK investment banking fees from M&A [mergers and acquisitions] and loan financing were derived from private equity backed transactions in 2005. Over 80% of the total £27bn of new capital raised by UK private equity firms in 2005 came from sources outside the UK. What's more, almost 60% of the total capital invested by UK firms during 2005 was committed to companies within the UK, demonstrating a positive net inflow of capital into the UK economy.

The second response by the industry has been to accept that it needs to become more transparent, that given the industry's size and influence it needs to go beyond the legal minimums with respect to governance and disclosure norms. In March, 2007 it announced the establishment of a working group to consider proposals for greater disclosure. The press release read:

Sir David Walker to chair private equity working group on disclosure

> The BVCA will establish a high level industry working group to produce a voluntary code addressing the transparency of the industry and levels of disclosure. The working group will recognise the very different types of investment and issues relating to different segments of the industry from small start-up financing to large buyouts. It will also take account of the size of the portfolio companies concerned.
>
> This has received support from across the industry.
>
> Sir David Walker, Senior Advisor at Morgan Stanley International (former Chairman of Morgan Stanley International, former Executive Director Bank of England, and former Chairman of Securities and Investments Board) will chair an independent industry working group tasked with drawing up a voluntary code addressing the levels of disclosure in the industry and how it should communicate with a wide range of stakeholders.
>
> […]
> Rod Selkirk, Chairman of the BVCA, said:
>
> "This initiative reflects the coming of age of the private equity industry as a mainstream asset class in the UK. We recognise that the industry's success has led to growing and legitimate interest in its activities."
>
> "We plan to build on our existing high-standards of transparency and openness to our investors by increasing the level of disclosure to a wider group of stakeholders."
>
> "This working group will be fully attentive to the need to avoid any additional reporting burdens on the smaller companies backed by private equity and venture capital."[23]

[23] BVCA press release