

M&CO Newsletter

Special Feature – The Hedge over Private Equity?

According to the Oxford Dictionary of Australian Investment Terms, a hedge fund is a type of investment portfolio where the fund manager can use a number of higher risk investment techniques, including derivatives, short selling and borrowing, in order to generate a higher return.

Private equity (PE) firms establish funds to invest in companies whose shares are not publicly traded, or to privatize public companies. The funds made available to companies are often comparable in size to those available to businesses whose equity is quoted on a stock exchange; however PE arguably offers significant advantages. Venture capital is basically private equity that is primarily targeted at businesses at an early stage of development.

Jack Welch is former long term global CEO of General Electric & spent the '80s involved in dozens of leveraged buyouts. He thinks the controversy surrounding private equity today is pretty similar to the LBO movement in the late 1980s. Jack worked with private equity firm Clayton, Dubilier and Rice & that experience has confirmed for him why private equity deserves not disdain by appreciation: Private equity, he says, almost always creates thriving businesses by making a company's vision clear and goals measurable & tightly aligning them with compensation systems. It creates an exciting ownership mentality, unleashing renewed passion from employees. Can't regular companies do all the same things? Some do, but too many do not for entrenched management, inertia, fear of change, and neglect. Too many companies also fail to install the kind of governance you find in private equity firms where owners and managers take the place of directors who fly in every other month to maintain the status quo. In private equity, board meetings centre not on questions like "Has anything happened to embarrass us lately?" but on comments such as "Forget the quarter. Make the investment." "Put it all together and no wonder private equity makes companies so competitive." But private equity has also been responsible for widespread wealth creation. The pension funds of

teachers unions and all types of employees in the public and private sectors are major beneficiaries. Private equity has done more to enhance the security of retirement funds than most other kinds of investment. Winners include millions of ordinary workers. Private equity thrives when businesses

underperforming can be bought at attractive prices with low-cost money. Inevitably, those deals dry up.

The PE industry in Australia has been experiencing strong growth. PE backed companies are a major employer group, providing jobs for up to 650,000 Australians or 8% of total private sector jobs. Australian technological innovation and R&D commercialisation are some of the main benefits of PE investment: 3/4 of invested companies launched new products in the past year whereas only 27% did so prior to their PE investment. Also PE invested companies generally have strong corporate governance & share profits with employees. In fact almost 80% of them distributed some of the wealth created by the business through employee share options programs and bonus plans.

PE enjoyed a year of mega-merger and acquisition activity in FY07, which Thomson Financial reports was worth \$292 billion, more than double the previous year, with 25% + sourced overseas. Overseas institutional investors & foreign pension funds accounted for 1/4 of total capital committed. A large number of companies are still being targeted, as favorable conditions are expected to continue for the foreseeable future.

Global players such as US's Kohlberg Kravis Roberts & Co (KKR) and Texas Pacific Group (TPG) have already made substantial recent investments in Australia. KKR paid A \$1.8bn for Brambles' waste management and industrial services businesses, while TPG invested A \$1.4bn to buy the Myer retail chain. KKR and CVC Capital Partners last year both exploited a shake-up of Australia's media landscape, with KKR entering a partnership with the Seven Network to establish a TV broadcasting, magazine and online business, CVC taking a 50% stake in a media venture with Nine Network owner Publishing and Broadcasting Ltd.

According to a score-card prepared by Thomson Financial, the IRR per annum on private equity in Australia for the period to 30 June 2006 was 19.2% for one year, 29.4% for three years, 14.8% for five years and 12.6% for 10 years.

Australian financial services regulators and industry leaders are echoing overseas concerns about the high PE multiples being paid in many buyouts and the level of debt. However, Australian banks are

positioning themselves to exploit any opportunities the surge may bring.

Australia's economic performance over the last fifteen years of economic expansion, a rarity among industrialized nations, while unemployment and inflation are both low, makes it a very sound destination for foreign investors.

Hedge funds are set apart from 'traditional' investing because they don't try to match or outperform a particular benchmark or index, "they aim to deliver positive returns despite what happens in underlying markets", they use unorthodox investment techniques to take advantage or short-term trading opportunities.

Although they've been around for decades, hedge funds started to attract significant attention during the 2000 – 2002 sharemarket downturn. During this period, hedge funds were able to deliver positive returns when markets were going backwards.

Encouraged by these results, a lot of money poured into the US hedge fund sector and there has been a corresponding increase in the number of hedge funds in Australia.

Because hedge funds have been extremely profitable, there has been an increase in the number of competitors in the industry. Not all those players have been successful, and a lot of investors haven't been getting the returns they expected.

The number of new funds, and the amount of money invested in them, has made markets more efficient and removed a lot of the short-term opportunities that hedge funds were good at exploiting. The result has been that returns from hedge funds have looked a lot like the underlying markets they have tried hard not to copy. The reason traditional managers generally deliver negative returns when markets are down and positive returns when markets are up, is that their portfolios often don't stray too far from the index against which they are measured. So if a company makes up 5% of an index, an active manager in the traditional fund sector might invest 7% of the portfolio in that company if they like it, and 3% if they don't. As a result, their returns still track the market reasonably closely.

Everyone wants a consistently positive return on their investments, and this can make hedge funds appealing. But there are negative aspects to hedge funds. They use a lot of borrowed money, which creates more risk.

They have to generate a higher 'headline' return than traditional investments to compete on an after tax and fees basis. Due to their high level of trading, most aren't very tax-efficient and they generally charge higher fees than traditional investments.

"Because the returns are not dependent on traditional investment markets, the results are more dependent on the manager's skill than with traditional investments. This means investors need to do even more research to ensure they get what they expect and pay for when they select a hedge fund."

"You don't often know what the manager is investing in at any point in time."

Main driver is the insatiable appetite of sponsors and banks to write deals. Australia's corporate landscape' relatively untapped seam of quality assets in a strong and growing economy, together with relatively cheap and plentiful capital: this country has the World fourth largest pool of managed funds with in excess of A \$1 trillion under management, as well as the highest per capita investment in managed been historically low in Australia representing good value. Nonetheless, we are now seeing buyout attempts of previously 'untouchable' assets & family businesses that have succession issues or are capital-constrained.

Collateralised debt obligations (CDO), like those at the centre of the recent meltdown are being used by investment managers that do not understand them, according to Merrill Lynch Investments first vice president Peter Opie who said it was not just advisers and their clients that did not possess the technical ability to trade in CDO's.

"Many of the sophisticated wholesale investors, institutional investors and asset consultants don't understand them either, I don't think they truly understand the risk. They have good return profiles in good markets, but they have equally poor risk profiles in bad markets. Financiers fail to understand that they can actually end up losing more than the principal if enough components of the CDO fall over."

CDO's contain debt instrument with varying degrees of risk. The riskiest containing non-investment grade bonds or Junk bonds are referred to as "equity." Sub-prime mortgage backed securities are an example of equity. CDO managers will leverage these equity investments to increase the yield to investors, however should the underlying bonds default the CDO unravel.

Investors are clearly attracted by the high yields on offer, given the lack of a term and credit risk premium in more traditional defensive assets.

“By treating their exposure to these types of assets as being quasi-defensive, investors failed to properly value the risk premium required for the underlying liquidity risk and downside risk potential of these structures – or more likely they simply didn’t appreciate that this risk existed.”

An underlying default in one of the lower-rated, higher-leveraged tranches can cause a CDO to start to unravel. Typically a CDO may have 200 bonds. If one defaults, the coupon may go from 12 per cent to 5 per cent. If there are two defaults, you may not get a coupon. If three unravel, you are at risk of losing capital and, roughly, if you have five defaults all your capital is gone,

While issuer defaults in the CDO structure will reduce the returns available to equity holders, high levels of defaults can result in capital losses. They can be a legitimate asset class when used properly, but they are just not understood well enough.

In the latest Merrill Lynch Global Fund Manager Survey, 72 % of 186 fund managers pooled said credit (default) risk was an elevated threat to financial stability.

In an address given in Sydney in September, the Governor of the Reserve Bank of Australia, Glenn Stevens described the impact of the sub-prime meltdown in the following terms:

“For a number of years now, many commentators have expressed concerns about the under-pricing of risk in financial markets, with investors increasingly willing to purchase risky assets at high prices and often with considerable leverage. Easy credit conditions accommodated and encouraged these trends.

“Over the past couple of months, we have witnessed something of a reversal. The initial trigger was the deterioration in the US sub-prime mortgage sector, itself a result of declining credit standards and a slowing US housing market. Since the exposures to these risks had been spread via securitization into global financial markets, losses are being borne in most parts of the world, including in Australia and some countries in Asia.

“Those losses have been coming to light only slowly, however, in part because the complex and opaque nature of some of the financial instruments in use makes valuation difficult, or even impossible under adverse conditions. In some cases, there simply is no market for, and hence no way of providing an objective valuation of, the claims in question.

“In the ensuing climate of uncertainty, investors rapidly have become quite risk averse, and some parts of the global capital market have suffered severe dislocation. In turn, institutions that rely heavily on wholesale capital markets, either for balance sheet funding or to securitise assets they have originated, have experienced difficulties. So-called conduits, credit arbitrage funds and various other vehicles often issued short-term commercial paper to fund their assets. This strategy, which was in some cases designed to avoid capital requirements for loans held on banks’ balance sheets, can carry significant maturity mismatch and hence funding risk. When investor attitudes changed abruptly in early August, asset-backed commercial paper markets around the world virtually came to a standstill, forcing many of these vehicles to tap lines of credit they had with banks.

“This, of course, transferred the funding pressures to the banks. Since there is a great deal of uncertainty about the likely demand on their own liquidity, banks have been conserving liquidity and have been reluctant to commit to lending to others for anything beyond a very short horizon. Institutional investors, which are now in a much more powerful position than a few months ago, have behaved cautiously and are demanding higher yields to accept bank paper. Hence, short-term funding rates have moved higher in a number of countries. In some cases, even overnight rates spikes sharply higher.”

Have we seen the last of the sub-prime fallout?

“I don’t think it is over yet. Too many people still need to unwind their positions.”

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JDM & Team, Brisbane.

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