The public face of private equity

Money talks and at the moment it's chattering loudly about the private equity trend driving takeovers, mergers and acquisitions and buyouts, writes *Andrew Pegler*.

Private equity, the now dominant supplier of global capital, is reshaping public sources of capital to fuel initial public offerings and high-yield debt markets. One of the biggest players in the Australian market is Peter Yates, Managing Director of Allco Equity Partners. Allco has emerged as a key investor in the consortium to buy Australian icon Qantas for $11 billion in the largest private equity deal this country has ever seen ... so far.

Earlier this year, we saw the Alinta management buyout proposal and the Coles Myer board reject a $20bn offer from US private equity player Kohlberg Kravis Roberts (KKR). Research from UBS estimates this is the beginning of a wave that will see private equity reclaim $33bn of shares on the ASX over the next 12 months.

Allco scored a coup earlier this year when the cashbox fund took a major stake in credit risk information provider Veda Advantage after two private equity investors (Pacific Equity Partners and Merrill Lynch Global Private Equity) unveiled a planned $814 million bid for the company. Allco stands to make a $40m profit from its stake. The Veda deal will be the first foray into the Australian market by Merrill Lynch Global Private Equity.

Monash Business Review readers may be familiar with 46-year-old Yates from his service to the Packer empire from 2001 to 2004 as CEO and MD of PBL, Chairman of e-corp, ninemsn and Ticketek, and a director of Crown and Foxtel. Before that, Yates spent 15 years with Macquarie Bank (who has joined him in the Qantas deal) in public company mergers and acquisitions (M&As) as well as large-scale structured financing. Needless to say, Yates has the sort of form a private equity disciple needs which is good because, at the moment, private equity is the 'new black'.

According to the AVCAL/ Thomson Financial annual report, private equity raised in Australia was $4.1 bn over the year to June 2006, and the total under management stands at around $23bn. Over the financial year to June 2006, a total of $2.3bn was invested by private equity, a 20 per cent increase over same period in 2005. A local private equity success is Repco and Pacific Brands. Pacific Dunlop ran into trouble with both companies before private equity rescued them, turned them around over two to three years and then re-listed them to make investors five times their capital investment.

"The future for private equity is very bright as more and more investing goes through wholesale funds seeking higher and different types of returns," says

Yates. "Wholesale funds have started to appreciate that publicly-listed companies have inherent challenges in their decision-making process that unlisted entities don't. Put simply, the decision-making process at publicly-listed companies is not optimum and an unlisted environment delivers better decisions and results.

"Also, the public company share price is very vulnerable to information, quarterly reports and external shocks. Bad figures that may not be related to the core strength of the business affect share price and cause chaos internally and this does not help in terms of long-term planning," explains Yates. "The boards of companies owned by private-equity are focused on the medium-term goal of listing or selling a company so there is less temptation to chase short-term results. Also, a private-equity board is very involved in the running and managing of the business and board meetings are generally far more constructive because of that."

Yates initially hesitated when Macquarie Bank offered him a role in its $11.1bn Qantas buy-out plan, but eventually he got on board and not only put capital into the deal, but became its biggest investor, sinking a staggering $980m for a 35 per cent voting stake in the consortium.

Although Yates could not comment on anything to do with Qantas, he did share with *Monash Business Review* some insights into a few private equity strategies and challenges. "First and foremost a private equity firm wants to invest in a business that offers a combination of growth and stable cash flow with a good return for the people involved; a few years ago this was a 25 per cent but it's come down to around 20 per cent today. The next challenge is to find such a business. The reality is, I may have to invest in businesses I don't know a lot about so the key is co-investing with partners who can off-set this knowledge balance."

In the case of Qantas, that partner is stablemate Allco Finance Group (AFG) whose chairman, David Coe, also chairs Allco Equity Partners. Allco Finance leases about 10 per cent of all Qantas planes and has a major stake in managing Allco Equity Partners'

What's the next big thing? Yates says:

"The mobile phone is the most powerful media device ever invented and where we are in terms of evolution of content and consumer application, beyond the traditional role of just talking, is basically where the internet was in 1998.

"Unlike the other assorted media options it is the only device that engages with all the senses, plus it is portable. It has one other extraordinary benefit: a billing platform pregnant inside it. I am privately investing in a number of plays in content and communities and am very excited by the possibilities of the new Telstra 3G which penetrates into car parks and buildings."

investments. AFG will put in $300m for an 11 per cent voting stake.

A favorite subject of private equity investors is the 'exit' or 'flip'. "The exit is when you sell your ownership in the business after it has achieved the most it can under your stewardship," Yates explains. "The time-frame varies depending on the industry and size of the investment. Our firm has a longer term horizon than most. The thing about us is that we have a fund that we have managed for 25 years. We don't return the capital. But most private equity companies might have a 10-year plan in which they have to be fully invested by year five and start returning capital before year seven."

Over many years on the upper echelon of the corporate ladder, Yates has sat at the boardroom table with some powerful figures – none more so than the late and legendary Kerry Packer. "I learned a huge amount from Kerry. We had lunch every Wednesday and talked widely about business and leadership issues. He had many strengths, particularly when it came to problem solving. He used to do what I termed 'crush the cockroach'.

"The cockroach is the problem and when he was in problem-solving mode there would not be the tiniest bit of fur on the tiniest bit of the poor beast that was not comprehensively and utterly crushed. Sometimes I would argue he went too far but I think it served as reminder to the board that all problems should be totally eliminated. His other great strength was that he was a phenomenal listener. He could get all sorts of information out of you and that made for more creative and ultimately better quality decision-making."

The stars have aligned for private equity. Racing equity markets over the past few years have left a lot of people awash with cash and that, combined with the short-termism of the publicly listed company and its onerous continuous disclosure regime, plus recent tax changes exempting foreign investors from paying capital gains, means that, for now, the sky's the limit for Peter Yates and his private equity cohorts.

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Who's next?

Deutsche Bank's analysis of the private equity potential of some of Australia's largest companies makes for interesting reading. The crucial measurement for managers in determining the appeal of an investment is the internal rate of return (IRR) which, until recently, was above 20 per cent. However the progressive rise in the scale of deals last year plus higher fees have pushed this down to 15 per cent. To attract shareholders to sell, a private equity company must offer a control premium which Deutsche Bank researchers assume is 20 per cent moving forward.

Boral

A buyout doesn't seem capable of generating sufficient return. At the current share price, and assuming a 20 per cent control premium, it offers an IRR of only 10 per cent. Despite cyclical cash flows, it could wear high gearing and there is some recovery in housing activity in both Australia and the US, but the upswings may be moderate given the extent of the respective booms. The divestment of one or more divisions could also be undertaken, but may not enhance the return greatly, partly because the significant control premium needed for these businesses in the first place.

TEN

The rise in its share price over the past six months makes a private equity buyout less likely. Ten has an IRR of 2 per cent if acquired at the current share price, and lower if a control premium were paid. Some cost savings would be possible (about $5m) per year and the company is well run, but earnings are stymied by ad spend lost to new media and increased network competition.

Fairfax

FXJ is likely to be more difficult for private equity to generate an adequate return from after a 30 per cent increase in share price over the past six months. Even if geared as aggressively as PBL's and SEV's recent media joint ventures with private equity, it is still unlikely to generate adequate IRR.

Orica

ORI is an attractive private equity target because its share price hasn't risen much over the past six to nine months. Acquired at the current share price, its IRR is estimated at 27 per cent or 18 per cent with a 20 per cent control premium ORI's cyclical earnings limit its potential gearing, and a net debt of 5x EBITDA, and EBITDA interest cover of 2.7x at its low is assumed. However it is set for solid growth and could reduce costs by $100m over four years.

CSR

CSR offers interesting possibilities, but its potential IRR remains sensitive to the share price paid. It trades a little under 7x 07 EBITDA, and could arguably be leveraged in the current climate with net debt of around 5.5x EBITDA, implying the initial equity contribution in a buyout could be about 20 per cent of total funds. A break up of its three divisions would still generate an IRR of around 15 per cent, but a 20 per cent control premium would reduce this sharply as the purchase price would exceed the sum-of-the-parts valuation.

Fosters

Fosters may be of interest to private equity, but with a control premium of 20 per cent its IRR would only be 14 per cent. Its relatively stable cash flows allow substantial gearing and there is scope for good operating earnings growth. Savings are still coming through from the Southcorp acquisition, further consolidation of production and distribution facilities and other supply chain savings. Also by exerting greater buying power on suppliers, it's partly offsetting pressure from the large retailers.

Source: Deutsche Bank Australian Equity Strategy February 2006