

Corporate Governance: Barbarian's at the Gate, again.

By Paul A Zaman MBA, MSC



Paul Zaman shares insights on the dynamics & role of private equity in the capital markets.

The most influential business event of all times - Barbarians at the Gate - is the definitive account of the largest takeover in Wall Street history. Perhaps history is repeating with the current corporate activity.

One of the merits of a company becoming listed, that is a public company, is that it strengthens its corporate governance and as a result improves the creation of long-term shareholder value. In the late 1980s and continuing today the thrust has been for entrepreneurs to grow their businesses and get listed on a public stock exchange. Listed companies grew organically or by acquiring usually smaller listed and unlisted companies. In the last few years we have seen the growth of private equity, in limited partnership vehicles acquiring public listed companies and taken them private again. Two explanations are that perhaps we have come through a 10 to 20 year cycle of private versus public companies and private corporate governance is more effective today than public corporate governance. In the 1980s private equity was huge and created a new market called junk bonds. This collapsed with many people going to jail. The rise of private equity has raised the red warning flag. The Financial Services Authority in England issued a discussion report in November 2006 heightening risks. In the UK in the first half of 2006 £1.2 billion was raised by private equity funds. This was more than the money raised in IPOs in the same period. Also club deals has meant that even the largest of public listed companies are targets, as seen by a US\$33 billion proposed acquisition of USA based American health care company HCA.

Lets start with folklore and history. The book Barbarians at the Gate tells the story of a private equity group called KKR, Kolbert, Kravis, Roberts, who did a massive S\$25b leveraged buyout (LBO) of RJR Nabisco in 1988 of total enterprise value of US\$31b. RJB Nabisco was an American Icon at that time. Leveraged buy-out firms succeed by finding a likely looking company, buy it, and when the value goes up, they sell out at a nice profit. There is nothing wrong with making profit in theory or practice. What was mystical and new in the 1980s was that the group of people pooled their limited money and they borrowed the majority. In the

financial media, these deals are called LBOs, 'leveraged buy-outs'. In the 1980's these private equity groups raised money buy issuing corporate bonds, known as junk bonds due to the high risk with the high interest rates paid from the target companies cash flow. Hence the best targets were those companies that had strong cash flow, often in retail or defence sectors. All was well until it became too big, too fast, too secret, and the fees too greedy. The loans involved became gigantic, as large as some nations' deficits. They're different from the publicly listed companies in that they don't have to give out very much information about their activities. A global game started of pass-the-junk bond-parcel that had the debtors, investors, and regulators spinning in the 1980s. A junk bond is any corporate bond issued by a company that does not have an investment grade credit rating of BBB or above. Junk bonds were ubiquitous in the 1980's through the evangelic efforts of investment bankers like Michael Milken. Michael Milken, is created for being the market leader for high yield bonds during the 1970s and 1980s at the investment bank Drexel Burnham Lambert, whose junk bonds fuelled the LBO boom in the 1980s. He served under two years in prison on finance related charges and paid fines and settlements of US\$900m. Currently he has net worth of around US\$2 billion and is a recognised philanthropist such as the Prostate Cancer foundation and Faster cures think tank.

In 1987 Oliver Stone directed a film called Wall Street, about

the villainous leveraged buyout king, Gordon Gekko, played by Michael Douglas. It however has been an inspiration for many aspiring private equity players. In the movie Gekko makes a speech "greed is good". He asserts that traditional iconic American industrialists like the Carnegies and Mellons managed business they had significant stakes in, whereas corporate America now had well paid company senior executives

whom owned very little and had little stake in the company's performance.

Nearly US\$180bn was invested globally by private equity firm in 2004 and funds raised in 2004 grew to 112b – a huge war chest. Major USA firms include: KKR, Blackstone, Texas Pacific Group, Bain Capital, Carlyle Group, Madison Dearborn, Clayton, Dublier & Rice, TA Associates, Harvest partners and Warburg Pincus. Major European firms include: Apax Partners, Bridgepoint Capital, Candover, Cinven, CVC Capital Partners, Permira, Terra Forirma Capital and 3i.



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An issue put forward as criticism of private equity firms is the lack of transparency, because these companies are not publicly listed, they are not as accountable to the public as other companies. It's certainly true that private equity firms are far less transparent in terms of the whole corporate triple bottom line reporting but they are highly accountable and highly transparent, perhaps more so than public listed companies to the people who've provided the equity and provided the debt. Also in industries like insurance or banking where there are prudential needs, they are just as transparent to those regulators as a public company.

The US Department of Justice has requested all documents and electronic communications in what are called club deals, done in the United States since 2003. A club deal is when these firms get together to buy a company. Two of such firms are the Carlyle Group and KKR. The Justice Department is concerned about possible collusion.

When it was all just wealthy individuals doing private business, no-one was too worried. But that's now changed, as the private equity firms are raising billions from pension funds, which is very much money belonging to the general public.

The UK Regulator, the Financial Services Authority is actually more concerned with the risk of market abuse. When big sophisticated investors get together and trade information about public companies, there is scope for market abuse and manipulation. When you're structuring a private equity transaction you must get access to a lot of detailed information about the company that you're targeting. Information on how well that company is doing, what its growth potential is, to get a accurate evaluation of the company. The concern is that the confidential price-sensitive information might be used to trade in the open public market. These giants are also creating global complex deals that spread across different jurisdictions and through a complex array of holding companies.

The private equity firms, Newbridge and Texas Pacific, took over the Myer department stores at the beginning of 2006 in Australia. They'd borrowed money to finance the deal from big financial institutions and in line with a new global trend for private equity firms, they also ask retail investors to buy a Myer note. The current bank deposit rate in Australia is around 6% the Myer note pays 10%. Higher interest rates match higher risk. If for whatever reason Myer could not service the debt and notes, the Myer note investor could have all of the investment at risk.

The private equity executives once again like the 1980s are arguing that the public companies are fat and lazy. They

have under performing capital structures and they are inefficient. They need to be made more efficient. The best way to do that is to go private. This inevitably means cutting costs and staff.

A public listed company with long term institutional investors, are focused on the long-term developing new business, incubating new ideas, research and development. Some people claim that private equity firms buy with a view to selling, typically within a three to five year time frame, although some transactions have been faster. Private equity firms therefore have a short to medium term focus and their exit is one of the three core exits:

- initial public offering and the flotation of the company on a stock market;
- trade sale to corporate body whose existing business model would be expanded, complemented r suitably diversified by the acquisition of the company; and
- secondary sale to other private equity funds.

Having largely shed the image of corporate wreckers, private-equity firms can now plausibly describe themselves as providing a safe haven in which firms can pursue long-term growth, sheltered from the short-term storms of the public stock markets. This role is all the more important, because both venture capitalists and buy-out firms work increasingly with firms undergoing big changes. Well-known firms that have recently been "nurtured" by private equity include Burger King, Polaroid, Universal Studios Florida, Houghton Mifflin, Bhs, Ducati Motor and the Savoy Group.

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