The private equity ideal

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Are private equity returns all about gearing levels?

Tim Martin: Gearing things up higher, even if you could do it, really doesn't deliver the kind of returns that you're looking for. It's all about earnings growth. We try and find the right business to start with. It's always good to grow when you've got a tailwind behind you, rather than running into a headwind, so we spend a lot of time thinking about what sectors and what industries we want to try and get into.

Martin: When you take them to the next level, you have to do quite a bit. It is anything from information systems and technology and reporting through to building out and strengthening management teams. So for us it's not an uncommon story for a business to see profitability potentially go flat to even backwards in the first year whilst we're investing in the business so that you can then grow it for the two, three years beyond that. You get to the end of that story with a very good, strong business that has still got another five years plus of growth ahead of it. And that's ultimately what the next buyer of the business is going to pay for

John Brakey: [Leverage] is still important in terms of generating a return, but doing a deal, like, [KKR's 1988 purchase of US conglomerate] Nabisco, where you had 7¢ in the dollar equity and 93¢ debt – it can't be done. It's the most over used words in private equity, I think, but it's [about] operational value add.

Katherine Woodthorpe: I know of CEOs who have actually been quite surprised at the level of investment that a private equity company fund manager was prepared to put into the company to grow it. And that's where private equity is a model that is so different from capital markets elsewhere, like the public markets, where you have both the money available in terms of the capital, but importantly, the time to actually then get on with the strategy.

How do you identify companies to buy?

John Haddock: It's a mixture of your own proprietary networks and there's opportunities that are brought to us by various intermediaries, be it investment banks or small broker firms. Sometimes just a bit of your own knocking on the door yourself and seeing a potential opportunity and, at times, needing to persist with that opportunity for a fair bit of time. I think there's a mixture of patience and persistence required to find deals.

Julian Knights: We have what we call a shadow portfolio which is something we put a lot of effort into, where we try and identify for some reason a sector that's fragmented, or change that's happening in a particular industry. For instance, in drilling services,



Katherine Woodthorpe.



Tim Martin.



Julian Knights.



John Haddock.

the business Eastern Well that we sold to Transfield late last year started life as three separate family-owned drilling companies. They had hoped to go to the IPO market. It shut, but they needed capital. We had been

looking at drilling, and had decided there was an opportunity. If you look back to 2006/2007, you probably did get a new book every week from an investment bank.

How would you describe the level of competition for deals?

Knights: At the big end, it's fiercely competitive. If there's a transaction of \$600 to \$800 million or above, I think it's fair to say there's a lot of competition for that asset. Most family owners are aware of the market, aware of the different potential sources of capital. Roughly 60 per cent of our transactions over the 12 years have been proprietary. It's a bonus if a deal doesn't go to wider competition. Bolt-on transactions often tend not to be as competitive. You may be involved in a competition to acquire the initial foundation asset but you may then be able to actually build it without necessarily the same amount of competition.



John Brakey. Photos: Nic Walker

Haddock: At times you need to be opportunistic, but good companies tend to always have a fair bit of interest from a range of buyers.

Brakey: There are a number of the Aussie guys that just have really defined niches. I think that's one thing that whether it be investment banks, lawyers, accountants, you know, they're just getting a little bit smarter. They don't approach everybody. They approach those that they think could really have a run at it. Whatever you say about the Australian market, people in the US or in Europe would kill to be in this competitive dynamic. You know, even on Healthscope, there were only two bidders. In Europe, if you had an asset like that, there might be 20 or 30 financial sponsors plus all the trade. You know, it's just a different dynamic in this market and I think it's a very different market in terms of the competitive dynamics.

I don't think there's very much truly proprietary in the sense that it's just you and you're going to get a look at that company and they're not going to go and ask someone to get a reality check on the price you're going to pay. You know – okay, there might not be other private equity firms there, but I think people aren't just going to give a business away for cheap. Or the owner's a pretty smart guy and he will have a sense of – and often, a sense based off stock market conditions that might have been before the GFC or something, you know, or before the tech crash in venture space. Sometimes what you're bringing to the owner is actually the confidence that enables them to de-risk financially. You know, all their net worth is probably tied up in that business. They can take a bit of money off the table and by de-risking, they've got this burst of confidence and enthusiasm and they can go again on the next phase of growth with you as a partner.

Martin: Our strategy is a little different in the sense that we, in our firm, we're a bunch of former strategy consultants or business managers ourselves. So, we spend a lot of time thinking about what sectors do we actually want to get into in the first place and then we will actually generate lists of business operating in those sectors. Then we will go out, pick up the phone and go and meet them. Much like some of the guys talked about earlier here.

The output of that for us is in our last month, five out of six of the deals we did in that fund were proprietary and one was through an auction process. So, we look at auction processes as well but most of the deals that we see and most that we do are proprietary. You don't get to steal a business for a cheap price. We end up paying a good price for a good business because that's what it's worth. I've actually spent quite a bit of time – sometimes over several years – building a relationship with the owner such that it's actually not – it's an interesting conversation – it's actually not just the capital that they're actually looking to access.

By the time you get to the point where they're ready to do something, they want to do something with you because you've actually added value to their business along the way. And it's not uncommon for people we've been talking with to be reshaping their businesses and doing things to them before we even get involved because of some of the discussions we've had leading up to that. So, the best situation for us is where we've had time to build a relationship because then he gets just us doing a deal. We will sit down and we will actually share multiple comparisons to listed companies and so on with the owners to show that we're not trying to steal the business.

What impact are the challenging IPO markets having on your business?

Knights: Uncertainty that exits in the business community in Australia impacts on people's decisions, whether it's to buy stocks in an IPO or if a trade buyer is to buy things. Traditionally, across Europe and across the US, the IPO market is represented, typically, around 25 or 30 per cent of exits. So, the vast majority of exits don't happen to be IPO market. I guess maybe it was just the early stages of Australian private equity that you saw a higher number. But, in a way, it's always been the case that one of the benefits of private equity is that we can support businesses through periods when the IPO market isn't available. From an exit point of view, I suspect we're all looking primarily at trade or, potentially, secondary exits rather than the IPO market.

Knights: What we haven't seen in Australia in the last year or two is a lot of big M&A transactions. Often, when you see quite a lot of big companies taken private, then the market wants to see a set of new businesses coming into the market. So, in a sense, it's not really, I don't think, just a bout private equity. It's that it's been a relatively limited level of M&A volume in Australia. When that turns and businesses are taken out, then I think you will see a pickup again in the IPO activity.

Brakey: In Australia the fund managers don't want the overhang, so they have encouraged private equity just be totally out. That's pressure that is coming from the fund managers. You know, in terms of overhang and they see the market dynamics working here in Australia. And so it's not something that we necessarily have total control over. You know, the fund managers need to change their attitude around that. The listed equity fund managers need to change their attitudes around that. As a private equity investor, it's great that we can just get out and get everything back in cash, you know. That's kind of good for investors in a way, our investors. But that ongoing involvement with the company and making sure it's stabilised on market afterwards, you know, is something that I just don't know where that is going to end up. But it's interesting that it's this market that is very different to elsewhere.

What are foreign investors saying about Australia and sovereign risk?

Martin: We have been going through our fund raising over the last few months and as Katherine said earlier, there's no doubt, talking to international investors, there's as much discussion around you know how can they avoid the risk of the tax uncertainty and everything else as there is around your fund, your performance and how well things have been going. You have to go through and explain how it works with managed investment trusts and everything else. But it just diverts a huge amount of attention away from what foreign investors should be looking at.

Australia is 1 or 2 per cent of the global economy. People don't have to invest here. You know, it's not something that they're going to miss if they don't do it. They have got plenty of other options. That said, people want to invest here. LPs from overseas want to put money into Australia because the economy is in good shape. There are good businesses here, there are good opportunities here, but that tax problem just becomes a conversation that you just don't need to have and it's just a complete distraction.

Brakey: It's not just then about tax. It throws up issues around sovereign risk, you know, and people were so comfortable before that they knew the standards here and now they don't, and that's the big issue. Because at the same time, remember, they had the mineral resource of retax as well.

Woodthorpe: It's not just the big guys who are at risk, it's every part of the market.

Brakey: It's just taking a lot longer [to raise funds] and there's a lot more discussion around [tax] issues and trying to get people comfortable than really what there's meant to be.

Woodthorpe: Trying to explain to a New York or Mid West pension fund investor's lawyers what a managed investment trust is and they go, no, too hard. We're still not coming into line with the rest of the world in internationally recognised structures that investors can feel comfortable with.

Haddock: It's been a large distraction. You like the focus of the discussion to be around the performance and what you're going to do with the money. Getting that resolved as quickly as possible will help Australia and will help as it relates to us continuing to be an attractive investment destination and acknowledging that we are a country that continues to need foreign capital and capital even sort of domestically to grow.

Woodthorpe: The message is very clear that [investors are] cautious about Australia. It's not stopping us. It's changing our pricing, changing our risk profile and so we're not going in as much as we used to until we just find out what's happening until it all settles down.

Knights: We raised our first capital offshore probably about 10 years ago and I remember still quite vividly a meeting where an investor said well, I won't get fired if I don't buy Australia. We have made life very difficult for international investing to Australia. There is, you know, going back, the limited partner regime is a structure which is almost universal across the private equity world.

We still can't offer that clarity and certainty. If you were to ask the future fund they would probably say to you they would think twice about investing into a market where there was the degree of potential uncertainty that we have in Australia. There's still a lot of work still to do on being able to say to investors this is a great market. We've got great governance. We're an easy place to do business. We've got good companies to invest in, and, by the way, the structures to invest in them are the same as you see everywhere else. That would just remove such a layer of work and cost for al of us here.

Brakey: Yes, and I think that this works at two levels. I think one is, you know, for the Aussie managers that are looking to raise money specifically for Australia and New Zealand it's probably actually easier to invest in New Zealand from a tax perspective than it is in Australia.

Does private equity have an image problem?

Knights: Because we are private, inevitably we will always need to probably work harder at actually explaining what we do and the value that we add.

Brakey: Private equity has got a shocking reputation. Is it stopping us getting access? No. Is it stopping us doing deals? Maybe. And I think from the sense that you need to convince – you know, that's the initial approach. You need to get taken seriously initially so you've got to come in with a warm introduction, and once you've got that I think, you know, then the boards can actually see that. I still think at director level they don't fully understand what private equity does and how we do it. If I could just get the knife out though, I don't think the media helps. I think almost invariably when there's a media article about private equity, barbarians will be mentioned, leverage, asset stripping and job cutting almost invariably – and that's what you think about when you think about private equity.

Martin: For family-owned businesses, it's an interesting dynamic because part of what people are worried about as owners of those businesses, even if they're selling out, is the preservation of their legacy as well. They want their workers to be looked to. They want their management team to go on and be with an owner that's going to look after them and do nice things for the business.

We've definitely got an image problem that doesn't really stack up to what the reality of it is. I think, you know, the nice thing for us is the situations we find ourselves in. We actually get months or potentially years to get to know people so that starts to dissipate pretty quickly. The first thing you say is, you want to talk to someone about what it's like. Pick up the phone and talk to the management teams that we've got or businesses that we sold years ago and let them explain what the experience was like.

So what is your message about private equity's worth?

Knights: It's a very tough time for family companies to access the banking markets, and it's a tough time to access the public capital markets. At Ironbridge almost all of our focus in the last two or three years has been on buy-and-build or platform-style deals, certainly a heavy focus on family-owned businesses. There are quite a few deals that are currently being worked on where those businesses wouldn't necessarily have the capital to go to the next stage of their growth. So I think this is actually one of those markets where private equity can do what it's supposed to do.

Haddock: We all probably see one of the key benefits of the private equity model of the direct engagement between owner and manager, but also understanding that we're not managers, you know, we're directors ... we represent funds that own the business.

Woodthorpe: Australia is a capital-hungry country. Private equity provides capital to companies that couldn't get it otherwise. Those companies then grow and when we divest them they are a better company than they were when we took them over. We need that kind of capital in Australia. It doesn't exist otherwise.

What is the general sentiment of superannuation funds towards allocating funds towards private equity?

Brakey: I've been staggered at the attitude of the superannuation funds and what is driving those attitudes at the moment. This focus on fees – I actually think maybe that's a convenient front to hide behind if you don't want to invest in the asset class. The allocation of private equity is increasing everywhere around the world except in Australia. Why is that? Part of that is because defined benefit funds have gone and it's all the risk is back on the superannuation member themselves. Trustee boards don't have to hit a rate of return.

Brakey: The thing that baffles me is – if I'm a superannuation fund what's my allocation to? For most of them it's 30 or 40 per cent into Australian shares, right, and then I'm buying six companies for that. You know, you've got the four big banks and BHP Billiton and Rio Tinto, and it's kind of wow, you know, that's how you're going to deliver returns long term.

Woodthorpe: It's just crazy the way it's so concentrated. The other thing is also that they are sometimes withdrawing even when it has been delivering stellar returns to them. There are all sorts of things at play and not all of them are logic and not all of them are actually about delivering the best result to the individual superannuants at the end of the day.

Are you seeking to attract self-managed superannuation fund money?

Martin: It's not something we thought about to be honest. I think it's just in the too hard bucket. I'm not sure how it would work technically even if we did want to go into it, but it's not on the radar screen.

Woodthorpe: We've thought about it more on the bencher side but we can't figure out how to do it effectively.

Brakey: Tapping the retail market for private equity is the holy grail, you know. If you think about going into that part of the market and getting access to those retail investors that would be phenomenal. In practice you can't do it and think about the issues with the superannuation funds, the focus on MBR and fees, right, that's at the wholesale level and these guys have had to be sophisticated, thoughtful and well-educated.

Knights: The other practical problem is that one of the things about private equity is it tries to be efficient in allocating capital so all of our funds would have a draw-down model so that you only draw the capital actually when it's required and the challenge with a retail market that really nobody has been able to solve is how do you know that over five years within 10 days of sending down a draw-down notice that individual investor will be able to come up with the money that you need and therefore the models that have evolved have been quite inefficient in that people have had to draw the money upfront and instead of earning very small returns. It is tough to actually make that model even though I agree it probably should be part of that investment route.

Martin: I think there's a question around it as well which is what's the right risk profile and level of knowledge of different investors too, so I think you have to be very careful around that sort of thing. Not only is it hard work it's not necessarily right for the self-managed super funds either.

Brakey: There's really a timing issue, you know, there's a time horizon issue and even though it's superannuation things happen in people's lives where they might need to get – and so the advisers are worried about, you know, a fund with a 10 year lock-up and you extend for another two years. You know, that just doesn't sit with that model.

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