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Private Equity: The Modern Organisation?

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1. The Rise of Private Equity

- ❖ Private equity is now an important part of the business landscape. In the last year or so private equity organisations have participated in some of New Zealand's most high profile transactions. Examples include:
 - ❖ The Rank Group making a full takeover offer for Carter Holt Harvey as part of acquiring IPP's controlling stake.
 - ❖ Allco Equity Partners bid for Baycorp Advantage.
 - ❖ CVC Asia Pacific's notice of offer to takeover Restaurant Brands.
 - ❖ Rural Portfolio Investments consolidation of the rural services sector (Wrightson, Williams and Kettle and PGG).
 - ❖ Babcock & Brown's acquisition of PowerCo.
 - ❖ Deutsche Bank Capital Partners acquisition of CHH Forests in conjunction with Rayonier.

- ❖ The size and range of transactions they are undertaking is growing. In many cases they are competing in trade sales and winning.

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- ❖ The private equity trend is a global phenomenon. In a recent survey of private equity (November 2004) *The Economist* observed that:

"... the private equity industry has moved from the fringe to the centre of the capitalist action. In the 1980's private equity was a place for mavericks and outsiders: these days it attracts the most talented members of the business, political and cultural establishment including many of the world's top managers".

- ❖ The September 2005 edition of *The Economist* notes that:

"... between one-fifth and one-third of the mergers and acquisitions in Europe ... are financed in whole or in part by private equity ... [T]he trend is likely to continue."

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- ❖ In recent years the resources under the control of private equity firms have expanded rapidly. In 2004 private equity firms invested US\$302 billion, compared with around US\$100 billion in 2000. It is estimated that they returned more than US\$130 billion in capital, net of contributions in the same period. The figures for 2005 suggest that the strong trend continues.

 - ❖ This paper attempts to understand the forces driving this trend in private equity and draw insights for the challenges facing the boards of our corporations.

 - ❖ This presentation argues that the trend in private equity has three fundamental causes:
 - ❖ Unprecedented changes in our business environment.
 - ❖ The difficulties faced by publicly listed corporations in dealing with the challenges posed by this environment.
 - ❖ The 'superior' organisational architecture of private equity.

2. The New Business Landscape

- ❖ The world is experiencing an unprecedented rate of change in our social and economic environment. There are a number of forces shaping this change. Three of the most important are interrelated:
 - ❖ Globalisation of trade.
 - ❖ The liberalisation of formerly 'closed' economies.
 - ❖ The technology 'revolution' in communications and technology.

- ❖ In the last 30 years or so the entry into worldwide markets of Pacific Rim countries such as Japan, Hong Kong, Taiwan, Korea, Singapore, Thailand and Malaysia has had a huge impact on world product market competition and Western economies. Globalisation of trade has and will continue to affect the competitiveness of many of our industries and the shape of our economy.

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- ❖ The economic liberalisation and dismantling of central controls in Eastern Europe, China, India, Central and Latin America and other countries is amplifying the effect of the globalisation of trade. These economies are bringing workforces totaling 1.5 billion people onto world markets. This compares with the Pacific Rim countries workforces which total 100 million, and the US and European workforces which total around 275-280 million.

 - ❖ The impact of these forces is magnified and complemented by the 'revolution' in communications and information technology. The 'modern' technology revolution is:
 - ❖ Causing major shifts in countries' comparative advantage.
 - ❖ Fuelling the trend to 'outsourcing'.
 - ❖ Lowering unit costs and increasing scale economies in a wide range of industries.

 - ❖ The technology revolution still is in its early stages and is about to enter its 'deployment' period. It will continue to power the forces outlined above.

 - ❖ These forces are directly affecting the business environment, competitive landscape and strategic challenges affecting most New Zealand firms. They imply continuing pressures for competitive repositioning, corporate restructuring and industry consolidation.

3. Challenges for the Open (Public) Corporation

- ❖ The 'dominant' organisational form in western economies over the last century has been the 'open' corporation.

- ❖ Organisations can be broadly categorised into two forms:
 - ❖ The closed corporation.
 - ❖ The open corporation.

- ❖ Closed corporations include:
 - ❖ Sole proprietorships.
 - ❖ Partnerships.
 - ❖ Private companies.
 - ❖ Co-operatives.
 - ❖ Private equity firms.

- ❖ The difference between the two types is related to the degree of separation between ownership and control.

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- ❖ In the closed corporation there is only limited separation between ownership and control.
 - ❖ Usually important decision agents (ie members of the board or senior management) also own a significant share of the residual claims.
 - ❖ The ownership representation on the Board or within senior management gives simple and effective alignment between key decisions and owners' interests.

 - ❖ The open corporation is publicly listed and usually has a widely dispersed ownership.

 - ❖ It is marked by wide/complete separation between ownership and control:
 - ❖ This allows for specialisation between ownership and decision-making (boards and management).
 - Owners are specialist risk bearers, and do not need to have detailed specific knowledge appropriate for key decisions.
 - Boards and managers can be specialist decision-makers, with specific information and experience appropriate to the corporation's situation.
 - ❖ The owners appoint a board of expert directors as their primary control mechanism over the organisation.
 - ❖ Performance measurement, reporting and reward systems are in place to ensure the decision-makers act in the owners' interests.
 - ❖ But the owners reserve decision rights to remove the board and/or the chair in the event of company under-performance.

 - ❖ The board plays a central role in the open corporation. Ultimate responsibility for company performance rests with the board, which sits at the top of the corporate decision hierarchy.

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- ❖ The board has two main functions:
 - ❖ Overseeing the primary wealth-creating function of the corporation.
 - ❖ Ensuring that the wealth created is 'fairly' allocated among shareholders, management, employees and other stakeholders.

 - ❖ The ability of the corporation to capture benefits from specialised decision-making and ownership arrangements depends upon the robustness and responsiveness of three markets:
 - ❖ The market for managerial and board talent.
 - ❖ The equity capital market.
 - ❖ The market for corporate control.

 - ❖ The first (the market for talent) determines the quantity and quality of capability available to corporations for senior management and director roles. Clearly a 'thin' talent market impacts on the capacity of open corporations to create shareholder wealth.

 - ❖ The equity capital market arises from the tradability of corporations' ownership claims. It determines the price and availability of equity capital to each corporation. It also reinforces the open corporation's performance management systems by introducing:
 - ❖ Strong disclosure obligations.
 - ❖ Better information flows and visibility of value – both performance expectations and the impact of strategic decisions are rapidly impounded into the company's share price.
 - ❖ Monitoring by independent expert analysts and active investors which provides valuable feedback to the owners, board and management.

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- ❖ A market for 'corporate control' is facilitated by equity capital markets and enables ownership to be transferred when outside experts consider that a change of control will enhance value. Such value gains can arise from capturing synergies with other firms (scale or scope gains from consolidation) or from improvements in management decisions and capabilities.

 - ❖ Each of these markets is coming under increasing scrutiny and regulation:
 - ❖ The corporate control market is now governed by a relatively 'strict' Takeovers Code.
 - ❖ The equity capital market is facing higher standards of regulation from NZX rules and legislation affecting securities trading, disclosure, and securities issues.
 - ❖ The talent market (directors and managers) faces growing legal and reputational risks arising from new regulatory regimes and regulator, shareholder and consumer activism.

 - ❖ The regulation and scrutiny provides higher levels of protection for investors. But it also impacts the cost and flexibility of the open corporation:
 - ❖ Achieving a change of control is more costly and time-consuming.
 - ❖ New rules on disclosure increase the cost of capital for small and medium firms and increase firms' legal and competitive exposures; 'strict' enforcement of insider trading regulations discourage 'aligned' reward structures using shares and options; and tighter regulation of securities issues raises the costs of listing securities.
 - ❖ Legal and reputational risks affect the supply of board and managerial talent, and diverts board focus to 'compliance' at the expense of value creation.

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- ❖ The higher cost and reduced flexibility has only limited impact on very large, 'steady state' firms. But it significantly affects:
 - ❖ Small/medium sized corporations.
 - ❖ Firms and industries which need to restructure or reorganise their activities.

 - ❖ In New Zealand these developments are impacting on the 'competitiveness' of the open corporation (versus closed corporate forms) because:
 - ❖ Firms need to respond to the major changes in the business environment through restructuring and industry consolidation.
 - ❖ We are a nation of small and medium sized firms.

4. Private Equity – Organisations Equipped to Handle Change

- ❁ In his Presidential Address to the American Finance Association in January 1993, Professor Michael Jensen noted that specialist organisations which had been involved in venture capital funding provided a blueprint for managers and boards “... who wish to revamp their top level control systems to make them more efficient”.

- ❁ He noted that their “organisational architecture” was characterised by:
 - ❁ Agreements at the top level that prohibit headquarters from cross-subsidising one division with cash from another.
 - ❁ Significant equity ownership by managers and board members.
 - ❁ Board members who directly represent a large fraction of the equity ownership of each investee company.
 - ❁ Small boards of directors (usually no more than 8 people).
 - ❁ CEOs as typically the only “insider” on the board.

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- ❖ Jensen noted that these organisations also solved many of the information problems facing corporate boards of directors because:
 - ❖ As a result of the due diligence undertaken at the time of acquiring the business or making an investment, the managers and partners in these investment firms gained extensive and detailed knowledge of virtually all aspects of the business.
 - ❖ The boards had frequent contact with management, facilitated by the fact that their organisations had their own staff to assist them.
 - ❖ The organisations often performed the corporate finance function for investee companies, providing the major interface with the capital markets and the investment banking communities.
 - ❖ The close relationship between the partners and managers of these investment firms and the investee companies encouraged the board to contribute its expertise during times of crisis.

 - ❖ Jensen was referring to what we now call 'private equity' firms.

 - ❖ Private equity as an organisation form has evolved over the last 50 or so years. In broad terms the concept entails capital providers who supply funds to specialist private equity firms/teams (usually on a contractual basis) which invest in target companies. The private equity firms are incentivised on the basis of the value they create and the funds under management.

 - ❖ New Zealand examples include Morrison & Co (Infratil), GPG, Direct Capital, GSJB Were, Private Equity, Pencarrow Private Equity, Graham Hart and Craig Norgate. But New Zealand is now part of a larger Australasian private equity market which is 'headquartered' in Sydney.

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- ❖ The 'superior' organisational architecture (alignment between decision rights, performance measurement and reward systems) of private equity offers other advantages:
 - ❖ It is a low cost organisation form (small, 'closed' and usually avoids the high compliance and direct costs of the open corporation).
 - ❖ It generally avoids the legal and competitive exposures which open corporations face with their disclosure obligations.
 - ❖ It attracts high quality board and management talent for its investee companies because it rewards them well, avoids the glare of publicity and provides an environment for pursuing long-term growth and value.
 - ❖ It enables these organisations to make high quality decisions quickly.

 - ❖ In recent years private equity has also begun to match advantages that were formerly the preserve of the open corporation:
 - ❖ The benefits of specialised knowledge and capabilities; these organisations combine specialised industry knowledge with strong strategic, organisational and financial skills and can 'scale' or leverage these skills across a range of investee companies.
 - ❖ Ready access to low cost capital; fund managers and savings institutions are providing huge amounts of capital to private equity firms as they search for 'alternative investments' that offer high rates of return; private equity firms are also raising capital from stock markets (Babcock and Brown, Macquarie Bank, GSJB Were, Direct Capital etc).

 - ❖ The combination of superior architecture, specialised knowledge and capabilities and ready access to capital equips private equity to 'play' actively in the corporate restructuring and industry consolidation generated by the new business landscape.

5. Where To From Here?

- ❖ Private equity is currently benefiting from a 'bubble' driven by huge flows of investor funds seeking high return 'alternative investments'.
- ❖ This is likely to lead to subsequent adjustments as resources (capital and capability) are drawn into the private equity sector and returns are driven down. But these adjustments will not affect the 'competitiveness' of private equity as an organisational form.
- ❖ In fact the private equity market is itself becoming more competitive. The dramatic growth in the number of firms competing for funds is leading to specialisation (by industry or sector), mergers, 'clubbing' (joint investment) and even exit.
- ❖ Private equity is not a short-run phenomenon. It looks set to increase its preserve in the business landscape and its role in corporate restructuring and industry consolidation.