

Taking It Private

The Global Consequences of Private Equity

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1. <http://www.cdr-inc.com/index2.html>, accessed 21 August 2008.
2. The dotcom bubble refers to speculative and venture capital investment in new, overvalued, Internet-based companies (dotcoms) from 1995 to 2001. The bubble burst in 2000-1 when business and consumer confidence in the hi-tech industry suddenly dropped and dotcom share prices tumbled. The causes for the crash are themselves speculative: high profile court cases involving the unscrupulous business practices of several IT companies; the non-occurrence of chaos predicted from 1 January 2000 onwards because of a programming "millennium bug"; and unemployment among computer programmers because of increased outsourcing. To deal with the ensuing recession, the US Federal Reserve cut interest rates; in so doing it encouraged cheap mortgage lending, contributing to the current credit crisis.
3. "The New Kings of Capitalism," *The Economist*, 25 November 2004.
4. In April 2005, during the national election campaign in Germany, Franz Muntefering, then Chair of the Social Democratic Party (SPD), described private equity firms as "locusts." He subsequently published a "locust list" of companies that he circulated within the SPD.

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What do Bono, Jack Welch, John Major, George Bush (senior), Fidel Ramos, Arthur Levitt and James D. Wolfensohn have in common? Answer: they have all entered into the business of private equity – a new form of investment, ownership and power that has helped to rewrite the rules of the financial sector at the time of its greatest dominance over the world economy:

- Bono, lead singer of Irish rock band U2 and anti-poverty campaigner, is a partner in Elevation Partners, a private equity firm that specializes in media and entertainment deals and partly owns *Forbes Magazine*.
- Jack Welch, former CEO of General Electric and management guru, is a special partner at Clayton, Dubilier & Rice, Inc, which describes itself as "one of the oldest and most respected private equity investment firms in the world".¹
- Former UK Prime Minister John Major, ex-US President George Bush, former President of the Philippines Fidel Ramos, and former chair of the US Securities and Exchange Commission Arthur Levitt have all been at the service of The Carlyle Group, another top global private equity firm.
- James D. Wolfensohn, former president of the World Bank, founded Wolfensohn & Co. LLC in 1995, a private equity firm that invests in emerging markets.

In its early years, private equity – a type of investment that buys up companies so as to sell them on later at a higher price and that is remarkably opaque to public scrutiny – was a small and fragmented "niche" business. No longer. During the last two decades, private equity has moved from the periphery to the centre of global finance capital, developing its own distinct characteristics and dynamics. After the dotcom bubble burst in March 2000,² it became one of the biggest fads in the whole system. Until the "credit crunch" took over the financial headlines in mid-2007, newspapers and TV news channels were full of stories about multi-billion private equity buyout deals and their impacts on global markets. Supporters crowned private equity funds the "new kings of capitalism";³ critics labelled them "locusts".⁴

Does private equity matter? Is it any different from previous forms of capital? The answer is a resounding "yes". Private equity has a significant and distinctive influence on taxation policy, corporate governance, labour rights and public services, deeply affecting society, human rights and environment alike. Were they to be assessed in terms of annual revenues, several private equity firms would rank among the

Private equity is a central component of the world's financial system at a time when financial markets now overshadow the productive economy

world's top 25 corporations. The biggest five private equity deals have involved more money than the annual public budgets of Russia and India.⁵ Some executives of private equity firms earn billions of dollars in fees and profits, often at the expense of the companies they buy and sell and of these companies' workers.

As many big private equity firms have joined hands and now own a large number of businesses across the world, a new type of corporate conglomerate has emerged that has reshaped the way business is being conducted. Private equity firms do not take long-term stakes in the companies, but typically invest for just three to five years. Consequently, they show little interest in improving the productive capacity of companies or in launching new products and services. For private equity firms, every investment is simply one element in a portfolio of financial assets that moves in and out of companies as the market demands (rather than as the long-term health of the companies requires). Private equity has become an integral component of the world's financial system at a time when financial markets have overshadowed the productive economy.⁶ Insofar as it constitutes a new form of corporate ownership and thus of power, private equity poses new challenges to labour unions, NGOs and community groups. These challenges are especially clear in Asia, which became more attractive for private equity firms after the "credit crunch" took hold in mid-2007 and diminished the scope for big private equity deals in Europe and North America.

This paper looks at the global growth of private equity and its social, environmental and political impacts, using India as a case study of its growing importance in Southern countries. It concludes with an outline of private equity's vulnerabilities that may provide opportunities for public concerns to be addressed.

What is Private Equity?

Private equity is a broad term denoting any investment⁷ in assets or companies that are not listed on public stock exchanges. Shares in these companies are bought, sold and issued privately, not publicly. Private equity firms invest in companies at various stages of their development ranging from their very beginnings to their demise. So-called angel investors, usually individuals, finance companies during their start-up phases, while venture capital is put into firms during take-off. Most private equity investment, however, is concentrated on companies during the later stages of their growth or when they are in distress.⁸ Here private equity firms depend heavily on leveraged or borrowed finance to buy up companies – in fact, "private equity firms" and "buyout firms" have almost become interchangeable terms in the US and Europe.

Private equity funds are pools of capital managed and invested by private equity firms. A fund is usually structured as a limited partnership. The General Partner (the fund manager) has unlimited liability for the debts and obligations of the partnership, such as paying fund managers, advisers and lenders, while Limited Partners have limited liability and are not involved with the day-to-day operations of the fund. The General Partner receives a management fee and a percentage of the profits while the Limited Partners receive income, capital gains and tax benefits.

The Limited Partners – a variety of outside investors such as investment banks, pension funds, insurance funds, university endowment funds and wealthy individuals – are approached by a private equity

5. Service Employees International Union, *Behind the Buyouts: Inside the World of Private Equity*, April 2007, p.10. <http://www.behindthebuyouts.org/buyout-industry>.
6. Political scientist Ronald Dore describes "financialisation" as "the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketised securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles". See Ronald Dore, *Stock Market Capitalism: Welfare Capitalism: Japan and Germany vs. the Anglo-Saxons*, Oxford University Press, Oxford, 2000.
7. Equity investment refers to the buying and holding of shares in assets or companies.
8. "Distressed debt" refers to shares in a company that is either in or close to bankruptcy. Some private equity funds specialise in purchasing these shares at substantial discounts so that they can exert influence over the restructuring of the company in the hope of selling on later.

firm wishing to raise money for its funds. In the US, most private equity funds require potential individual investors to have \$1 million of net worth (exclusive of primary residence), \$200,000 of individual income, or \$300,000 of joint income (with spouse) over the previous two years and an expectation that such income levels will continue. The involvement in private equity businesses of pension funds, university endowments (for instance, Harvard University's \$34 billion endowment⁹) and sovereign wealth funds (state-owned funds comprising financial assets such as stocks, bonds, property or other financial instruments¹⁰) means that, in fact, a significant amount of money flowing into private equity funds is "public" in nature, not private. Yet these outside investors (the Limited Partners) do not participate in the funds' investment decisions at all. All these investors turned to private equity (along with other "alternative" investments such as hedge funds, commodities and property) and away from shares and government bonds in the hope of realising higher yields or returns on their money. National legal authorities have tended to regulate private equity funds less than other funds (such as mutual funds¹¹ or pension funds) on the grounds that the investors approached to contribute to them are wealthy and sophisticated, can take higher risks and have adequate other money to protect themselves from any investment losses without resorting to society or state funds.

With average life spans of 8-10 years, funds undertake several investments in target companies; usually no single investment exceeds 20 per cent of the total amount of money committed. Once investors have placed their money with a fund, it remains locked up for the duration of the fund's life cycle. Unlike investors in publicly listed companies, who can sell their shares at any moment (assuming someone else wants to buy them), passive investors in private equity funds cannot gain access to their money until the private equity firm sells or "exits" from the companies in its portfolio.

In recent years, various "funds of private equity funds" have emerged, which allow managers to invest in several private equity funds and thus give investors access to a much broader range of underlying companies in order to improve the risk-return ratio of their investment portfolio. It has been estimated that funds of funds accounted for nearly 14 per cent of the commitments made to private equity firms globally in 2006, according to UK-based research and consultancy firm Private Equity Intelligence.¹²

9. An endowment is a donation to an institution of money or property that has to be invested permanently or for a defined time period; the institution can spend only the interest on the investment.

10. See Kavaljit Singh, *Frequently Asked Questions About Sovereign Wealth Funds*, The Corner House, October 2008. <http://www.thecornerhouse.org.uk/summary.shtml?x=562749>

11. A mutual fund is a pool of money from several investors that has a predetermined investment objective. A fund manager is responsible for investing the pooled money into specific securities (usually stocks or bonds). By pooling their money in a mutual fund, investors can buy stocks or bonds with lower trading costs than doing so on their own. A mutual fund enables investors to spread their money across a diverse range of investments to reduce the risk of losing money if one investment performs badly. Many investors are individuals saving for their retirement. By law, mutual funds have to disclose information regularly, face restrictions on their borrowing, and usually have to hold a relatively liquid mix of assets.

12. <http://www.preqin.com>.

Private Equity and Hedge Funds

Private equity funds and hedge funds are often perceived as identical investment vehicles. Both are unregulated, highly leveraged and charge whopping fees. But there are vast differences between them.

Typically private equity funds buy up an entire company, gain management control, restructure the company and then sell it. That is, they invest in illiquid assets with a multi-year time horizon.

In contrast, hedge funds typically invest in liquid assets in financial markets, such as stocks and shares, bonds, currencies and commodities, which they buy and sell at breathtaking speeds without gaining management control.

Further, investors in private equity funds are "locked in" for the entire term of the fund, whereas investors in hedge funds can pull out their money whenever they wish, for example, if performance deteriorates.

Recent trends suggest that these distinctions are blurring, however. Increasingly, hedge funds are a source of the vast amounts of capital that private equity firms need to undertake their acquisitions. In the wake of the "credit crunch", they are taking on the role of lender that used to be associated with banks, thereby hoping to garner higher returns and diversify their risks.

Private equity affects taxation, corporate governance, labour rights and public services; it has grave implications for society, human rights and the environment

The Players

“Some financial investors don’t waste a single thought on the people, whose jobs they destroy – they stay anonymous, they don’t have a face, they invade companies like swarms of locusts, devour everything and then move on. It is this form of capitalism that we are fighting against.”

Franz Muntefering

Former Chair of German Social Democrat Party¹³

Who are the private equity firms? The five largest are The Blackstone Group, The Carlyle Group, Bain Capital, TPG Capital (formerly Texas Pacific Group) and Kohlberg Kravis Roberts & Co. (KKR). Together, they manage assets worth hundreds of billions of dollars. Their influence over the “real economy” can be gauged from the fact that these five firms alone control companies that employ more than two million workers. The top 20 such firms have an indirect hold over nearly four million employees (*see* Table below). The New York-based Blackstone Group, which started as a two-man team working out of a single room, now has close to 350,000 employees in its acquired companies worldwide. More than 500,000 employees work at KKR-controlled firms.

In 2006, their most recent peak year, private equity firms carried out more than US\$664 billion worth of corporate buyouts, according to data firm Thomson Financial. More and more companies that once were publicly listed on stock exchanges, from airlines to retailers to utilities, are now owned by private equity firms, including internationally well-known companies and brands such as Burger King, Jimmy Choo, Toys “R” Us, Dunkin’ Donuts, Polaroid, The Automobile Association, Debenhams, Madame Tussauds and National Car Parks (NCP).

13. Quoted in *Hedge Funds and Private Equity: A Critical Analysis*, PES (Socialist Group in the European Parliament), 2007. http://www.pes.org/downloads/Hedge_Funds.pdf.

The Top 20 Private Equity Firms

Private Equity Firm	Assets Under Management (\$bn)	Portfolio Company Employees
Blackstone Group	79	350,000
Carlyle Group	56	200,000
Bain Capital	40	662,000
Texas Pacific Group	30	300,000
KKR	27	540,000
Cerberus	22	363,000
Providence Equity Partners	21	86,000
Thomas H. Lee Partners	20	391,000
Welsh, Carson Anderson & Stowe	16	62,000
Hellman & Friedman	16	73,000
Warburg Pincus	15	375,000
Madison Dearborn	14	149,000
Apollo Management	13	297,000
TA Associates	10	28,000
CCMP Capital Advisors	10	379,000
Goldman Sachs Capital Partners	9	1,050,000
DLJ Merchant Banking Partners	7	63,000
Vestar	7	53,000
Silver Lake Partners	6	301,000
Clayton, Dubilier & Rice	5	109,000
Onex	5	167,000

Source: Service Employees International Union, *Behind the Buyouts: Inside the World of Private Equity*, April 2007, p. 20.

Once private equity firms buy out companies, they invariably downsize the workforce, slash workers' benefits and abrogate collective agreements between workers and management. Even the proponents of private equity admit that buyout deals lead to significant job losses, particularly in the initial years. The heads of private equity firms have tremendous power over the acquired companies' workers, executives and futures. "I can change a chief executive in five minutes," claims Jon Moulton, founder of a London-based private equity firm, Alchemy Partners.¹⁴

Unlike publicly listed companies, private equity firms are not legally bound to disclose information about their operations or those of the companies in which they invest or buy. As a result, they (and the companies they own) are shielded from the glare of public attention and from public accountability.

Private equity firms make extensive use of "leveraged" or borrowed finance to buy out companies – they borrow money to acquire a company's shares in the hope that the interest they will pay on the resulting debt will be lower than the returns they will make from their investment. In many cases, the levels of borrowing are unsustainable. Yet while private equity firms can easily off-load the associated risk onto the target company given their legal structure of limited liability, the financial institutions that lend money to the firms are exposed unless they can themselves sell on the loans. Such practices pose risks to the entire financial system, as the sub-prime mortgage crisis that has engulfed the US since mid-2007 has revealed (*see* Box: "The Sub-Prime Mortgage Crisis", pp.14-15).

Private equity investments can also threaten hospitals, water supplies and other public services because they place short-term financial objectives over the public interest. The way that the private equity business model exploits regulatory loopholes, tax arbitrage, and off-shore entities and transactions can further endanger the public good. Furthermore, when several big private equity firms join hands to buy a target company, the significant flow of price-sensitive and insider information about the target company's financial health and business activities between them creates considerable potential for market abuse.¹⁵

Private equity's importance is magnified further by its links with two other increasingly prominent financial vehicles: sovereign wealth funds (SWFs) – state-owned funds – and hedge funds (*see* Box: "Private Equity and Hedge Funds", p.3). The three investment vehicles reinforce each other in myriad ways. Some sovereign wealth funds, for instance, get involved in the private equity business. Temasek Holdings, a sovereign wealth fund owned by the government of Singapore, operates like a private equity firm, and is the largest private equity investor in India. The China Investment Corporation announced its decision in May 2007 to buy a \$3 billion stake in private equity giant The Blackstone Group. A few months later, in September 2007, Mubadala, a sovereign wealth fund of Abu Dhabi's government, bought a 7.5 per cent stake in The Carlyle Group for \$1.35 billion.

Hedge funds have also got in on the act. Old Lane, a US-based hedge fund, for example, has created a private equity fund that invests in India and other Asian markets. One reason this is important is that considerable sums of official reserves,¹⁶ which provide the liquidity¹⁷ for most financial markets, are now in hedge funds, taking up, by one estimate, some 25 to 50 per cent of hedge fund activity. When the big US-based hedge fund LTCM (Long Term Capital Management) collapsed in 1998, it came to light that the Italian central bank had invested

14. Quoted in Paul O'Keeffe, "The Rise of the New Conglomerates," *BBC News*, 10 February 2005, <http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/4249673.stm>.

15. Market abuse arises when someone uses insider information (rather than publicly-available information) to buy and sell financial products or to manipulate their prices to the disadvantage of investors without such information. It is illegal in many countries.

16. Official reserves are the assets of a country's central bank held in different currencies (dollar, euro and yen) that are used to back its liabilities, particularly the national currency. One major difference between official reserves and sovereign wealth funds (SWFs) is their investment pattern: official reserves usually undertake short-term investments in low-yielding liquid assets such as treasury bills while SWFs undertake long-term investment in illiquid and risky assets such as real estate.

A central bank is a national government bank rather than a commercial, private, investment or retail bank. Its two main tasks are "preserving the health of the financial system and controlling inflation". ("The Year of Living Dangerously", *The Economist*, 9 August 2008). It is usually responsible for a country's monetary and fiscal policy, controls the supply of money in the economy, sets interest rates, and issues national currency. Several countries, such as the UK and USA, have made their central banks independent of political control. The US central bank is the Federal Reserve; the UK central bank is the Bank of England; the European Central Bank (ECB) is the central bank of the European Monetary Union; India's central bank is the Reserve Bank of India.

17. Liquidity is a hard-to-define but commonly used term: "There is no universally agreed definition of this concept; best to say you know it when you see it." ("Bull Session", *The Economist*, 6 January 2007, p.10) The economic textbook definition refers to the ease with which an asset can be sold for cash at the expected price without causing any significant change in the asset's price. The term is often used simply to mean cash. Central banks (which hold official reserves) can increase the liquidity of the whole banking system's balance sheet by lending it more cash.

Recently, however, the term is also used as "a catch-all phrase to denote, variously, loose central bank policy rates, broad money supply growth, aggressive lending to private equity, yen borrowing and even the growth of debt derivative products". Concludes the *Financial Times*: "liquidity in its first, narrow, definition is an important economic concept. But in its more fashionable second usage, liquidity is too . . . wishy-washy to be useful" ("Defining Liquidity", *Financial Times*, 10 August 2007; *see also* "When the Rivers Run Dry: Can Bank Regulators and Central Banks Prevent Future Liquidity Crises?" *The Economist*, 8 March 2008).

Leveraged Buyouts (LBOs)

In a leveraged buyout (LBO), private equity firms borrow money to acquire a company or an asset, using the cash flow and assets of the acquired company as collateral. The acquired company records the debt on its balance sheet and its cash flow is used to repay it. This is why private equity firms generally target companies with a steady cash flow.

Leveraged buyouts enable private equity firms to undertake mega-acquisitions without themselves having to commit much capital. A typical LBO comprises 80 per cent debt and

20 per cent equity. Interest payments on debt, unlike income from equity, are not usually taxed.

If the acquired company is unable to pay back the debt used to acquire it, it can be forced into bankruptcy. For example, the 1988 buyout of the US department store company Federated Department Stores (which now owns Macy's and Bloomingdale's) failed due to excessive debt financing (almost 97 per cent of the total capital) and the company went bankrupt in 1990.

Private equity firms pioneered the leveraged buyout industry. KKR reportedly first used the strategy

when it acquired a majority stake in the Orkin Exterminating Company in 1964.

LBOs have been popular in recent years because of low interest rates and easy liquidity in the global credit markets. Between 2004 and 2007, roughly \$450 billion of sponsored LBO issuance poured into the leveraged loan market. But the current credit crunch could spell disaster for many LBO companies as banks and other lenders tighten their purse strings. The risk of default and bankruptcy rises every day.

18. Set up in 1994, Long-Term Capital Management (LTCM) had returns of over 40 per cent in its initial years. By 1998, it had built up a market exposure of some US\$900 billion. During one month in 1998, however, its net asset value fell 44 per cent when the financial markets unravelled after Russia defaulted on its debt. The hedge fund's near collapse triggered financial problems in the established financial institutions that had lent to LTCM, reduced the share prices of banks and industrial companies and damaged their credit ratings. Profits, jobs and growth were all affected. To stop the cascade, other financial institutions bailed out LTCM on the initiative of the US Federal Reserve. The fund folded in early 2000. See Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Fourth Estate, London, 2002.

19. Preference shares pay out fixed-income dividends before any other dividends are paid to ordinary shareholders. They grant preferential rights for capital repayment if the company is liquidated or goes bankrupt. They usually carry no voting rights and are classed as debt, not shares, on the company's balance sheet.

20. The Unlisted Securities Market (USM), despite its name, was a stock exchange set up by the London Stock Exchange (LSE) in 1980 on which companies could list if they were too small to qualify for a full listing on the London Stock Exchange, did not have a three-year trading history, or wished to float less than 25 per cent of their share capital. The LSE set up the Alternative Investment Market (AIM) in June 1995 to replace the USM, which discontinued in 1996. AIM is designed primarily for emerging growth companies that operate globally and are considered to be a high investment risk. There are now more companies listed on AIM than on the main LSE. Many non-UK companies chose to trade their shares on AIM rather than on a US stock exchange after the Sarbanes-Oxley Act was introduced in the United

\$250 million in it.¹⁸ Taken together, private equity firms, sovereign wealth funds and hedge funds are managing liquidity in the global markets to the tune of some \$10 trillion.

The Origins of Private Equity

Although it was not until the early 21st century that private equity hit the headlines, its origins go back to the mid-20th century to institutional venture capital financing in the UK and the US. Venture capital consists of small investments in the form of equity or shares in new start-up companies. Venture capitalists work closely with company entrepreneurs to provide various kinds of support to strengthen the relevant businesses. (This contrasts with private equity financing today, which has become increasingly identified with big leveraged buyouts that typically take place in the later stages of a company's life.)

In the UK, the Industrial and Commercial Finance Corporation (ICFC) was established in 1945 by various financial institutions, including the Bank of England, to meet the financing needs of small and medium enterprises (SMEs) that were constrained by the prohibitive costs of raising funds directly from the public through listing on a stock exchange or via banks and other lending institutions. Surprisingly, the ICFC had no state funding even though the initiative came from the government. For many years, the bulk of financing that ICFC (renamed Investors In Industry – or 3i – in 1983) provided to companies was in the form of preference shares¹⁹ and term loans rather than the prevalent equity buyouts of today. In the early 1980s, private equity businesses in the UK received a major boost when investment restrictions on undertaking buyouts were relaxed and the Unlisted Securities Market was created, which allowed start-up companies to offer shares to the public, thereby enabling small or new companies to raise funds for their business development.²⁰

In the United States, the first private equity firm – the American Research and Development Corporation – was formed in 1946 by George Dorios (known as “the father of venture capital”) to encourage private sector investments in businesses run by soldiers returning from the Second World War.²¹ As in the UK, the industry subsequently ben-

edited greatly from special tax and legislative measures introduced in the 1980s, such as lower taxes on capital gains and relaxed disclosure and investment regulations. Private equity firms shot to prominence in the US when KKR launched a hostile bid²² to take over US food company RJR Nabisco – a deal immortalized in the book, *Barbarians at the Gate* (“The rules were simple: never pay in cash, never tell the truth, never play by the rules”²³). Indeed, most of the deals in the 1980s and early 1990s were hostile takeovers.

Nonetheless, by and large, the global private equity industry remained relatively modest in the early 1990s, totalling \$10 billion in 1991. In the mid-1990s, however, business gathered pace, reaching a combined value of US\$700 billion in 2006. In the years 2006-2007, private equity carried out deals valued at \$1.4 trillion, “the equivalent, after adjusting for inflation, of about a third of all the buyouts ever done.”²⁴

Looking for Opportunities

Private equity firms have different set ups depending on the legal, regulatory and tax regimes in which they operate. Typically, the firms operate through a combination of onshore and offshore partnerships, investment trusts, and Special Purpose Vehicles.²⁵

Unlike investments in stock/share or bond markets, returns (or annual profits) on private equity are not linked to the performance of a stock market or an index.²⁶ The private equity industry works on a 2:20 principle. Typically, General Partners are compensated with an annual management fee of 2 per cent of the committed capital. Thus, a \$10 billion fund will generate \$200 million a year in management fees for its General Partner. In addition, the General Partner is entitled to “carried interest,” a performance fee based on profits generated. Typically, the General Partner gets carried interest of 20 per cent of the profits, although annual gross private equity returns have often been in excess of 20 per cent because of the higher usage of leverage. The 2:20 principle has remained intact despite the amount of money under management increasing significantly, creating a perverse incentive for General Partners to launch mega funds.

Classifying performance fees as “carried interest” has considerable tax benefits, giving the private equity industry its greatest competitive advantage over other investment vehicles. Existing laws in the US and UK treat this money as investment income rather than as earned income or wages. In the US, “carried interest” is taxed at the capital gains tax rate of 15 per cent rather than at the 35 per cent income tax rate applicable for wages and salaries. In the UK, similar tax concessions allow private equity firms to pay as little as 10 per cent tax, compared with the country’s 40 per cent top rate income tax. Unsurprisingly, the practice of “carried interest” has been sharply criticised – not least on the grounds that there are other sections of society that need tax exemptions far more than the multi-millionaire partners of private equity firms. As Nicholas Ferguson, chair of SVG Capital, notes, private equity partners “pay less tax than a cleaning lady.”²⁷

Thanks partly to these special tax concessions, the few individuals driving the global private equity industry are raking in fantastic sums. Performance data on 144 separate buyout funds during 1992-2006 shows that, on average, private equity funds could expect to collect \$10.35 in management fees for every \$100 they managed. Slightly more than half of this amount – \$5.41 for every \$100 – comes from “carried

Because private equity firms don't have to disclose information about their operations, they and the companies they own get less public attention – and are less publicly accountable

- States in 2002 (see footnote 33).
21. http://en.wikipedia.org/wiki/American_Research_and_Development_Corporation.
 22. A hostile bid is an attempt to buy or takeover a company without informing the company's board beforehand or after the board has rejected the offer.
 23. Bryan Burrough and John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco*, ArrowBooks, London 2004.
 24. “Loan Rangers: Private Equity and Banks”, *The Economist*, 30 August 2008, pp.81-82.
 25. A special purpose vehicle (SPV) is a legal entity or corporate body, such as a limited company or partnership, created to fulfil a specific, narrow or temporary objective, particularly isolating a financial risk such as bankruptcy, taxation or regulation. It may have several owners. The SPV owns certain assets (such as mortgage loans) in which it issues shares or securities (such as Mortgage Backed Securities). For more explanations, see Satyajit Das, *Traders, Guns and Money: Knowns and Unknowns in the Dazzling World of Derivatives*, FT Prentice Hall, 2006, 282ff.
 26. A stock market index is a selection of companies, usually large ones, listed on a particular stock exchange. The index measures the daily valuations of these companies' shares, and is considered to represent the performance of the whole stock market and thus of investor feeling about the economy in general.
 27. Quoted in Martin Arnold, “SVG Chairman Breaks Tax Taboo,” *Financial Times*, 3 June 2007.

interest”.²⁸ With buyouts running into tens of billions of dollars, key partners have extracted management fees of hundreds of millions of dollars each year to take home on top of their 20 per cent or more of the profits. No wonder the General Partners of some large private equity firms have become billionaires. According to US business magazine *Forbes*, the top 20 managers of private equity funds and hedge funds on Wall Street pocketed an average of \$657 million in 2006.²⁹ This compensation is 22,255 times greater than the pay of an average US worker.³⁰

The Buyout Business

“Take an underperforming company. Add some generous helpings of debt, a few spoonfuls of management incentives and trim all the fat. Leave to cook for five years and you have a feast of profits. That has been the recipe for private-equity groups during the past 20 years.”

The Economist, February 2007³¹

Private equity firms finance their operations not only through equity provided by the Limited Partners who invest in the private equity funds but also (and primarily) through debt in the form of loans from banks (although the banks have often transferred the resulting debt to other financial institutions through securitisation³²). In a typical leveraged buyout deal (*see* Box “Leveraged Buyouts”, p.6), the private equity fund tends to put in just one-quarter of the total capital required while the remaining three-quarters are financed through debt.

Private equity firms practise two distinct types of buyouts:

- Leveraged Buyouts (LBO), in which they use debt to take control of a business; and
- Management Buyouts (MBO), in which they help the existing management of a company to acquire it in return for gaining a stake in the company themselves.

The buyout process starts by taking a publicly listed company completely private – that is, the private equity firm buys up 51 per cent or more of the shares of a company listed on a stock exchange, enabling it as the majority shareholder to take it off the exchange. According to the proponents of private equity, this move frees companies from the pressures of meeting onerous or short-term performance demands from a diversity of shareholders, facilitating a more unified, longer-term perspective.

In reality, however, the buyout barons often make tougher demands on the company than conventional shareholders because they expect even higher returns over an even shorter span of time; even before they exit, they tend to extract dividends, and advisory and other types of fees on a regular basis. Taking companies private allows private equity firms to escape legal requirements for disclosure that would subject them to scrutiny from shareholders, public interest groups, environmentalists and trade unions. How the acquired companies operate need not be revealed even to the Limited Partners of private equity funds. Taking companies private also allows private equity firms to bypass the legal duty of complying with certain regulations (such as the 2002 Sarbanes-Oxley Act in the US³³). Indeed, lack of transparency is essential to the private equity business model.

Private equity funds provide not only capital to the firms in which

28. Andrew Metrick and Ayako Yasuda, “The Economics of Private Equity Funds,” 9 September 2007, <http://www.chicagosgb.edu/research/workshops/finance/docs/metrick-pe.pdf>.
29. “Big Paycheck”, *Forbes*, 3 May 2007.
30. Sarah Anderson, John Cavanagh and others, “Executive Excess 2007: The Staggering Social Cost of US Business Leadership,” The Institute for Policy Studies and United For a Fair Economy, 29 August 2007.
31. “Caveat investor”, *The Economist*, 10 February 2007, p.14.
32. Securitisation is a process that turns illiquid assets such as loans into liquid assets through the issuance of securities that are paid from the cash flows generated by such assets. Myriad kinds of loans have been securitised: auto loans, student loans, mortgages and corporate debts. The Residential Mortgage Backed Security (RMBS) is an example of securitisation based on a collection of mortgages. Securitisation became popular among international banks and financial institutions because it fundamentally altered the model through which they manage, price and distribute credit risk. By “removing” credit risks from their balance sheets, banks freed up regulatory capital, which they invested elsewhere and thereby earned more profits. The current credit crisis indicates that the banks did not, in fact, remove these risks. *See also* Box: “The Sub-Prime Mortgage Crisis”, pp.14-15.
33. The Public Company Accounting Reform and Investor Protection Act, commonly known as the Sarbanes-Oxley Act (after its sponsors Senator Paul Sarbanes and Representative Michael G. Oxley), Sarbox or SOX, was brought in to strengthen corporate accounting standards and procedures following the 2001 collapse of US energy company Enron and other major bankruptcies. It established new or enhanced financial reporting and disclosure standards for all US publicly listed companies and public accounting firms, but does not apply to privately-held companies. Its requirement for companies to produce an annual report in which outside auditors attest to their quality is expensive, especially for smaller firms. Such costs are encouraging some companies not to list on US stock exchanges or are pushing them towards private equity.

they invest, but also business “expertise”, usually assuming complete management control. Joining the boards of the portfolio companies, they have the final say over how the companies are run. They may save on cash flow by cutting costs and minimising investment, as well as firing workers and overseeing changes in senior management. But private equity firms also tend to rely on outside advisers and asset managers for advice and operational assistance, maintaining only a small staff themselves.

In the US and Europe, private equity firms tend to be more interested in mature companies that generate high cash flows than in those with high future growth prospects because companies with high cash flows have an easier time servicing the additional debt that their private equity investors take on during buyouts.

Private equity firms try to increase the value of the companies they buy or invest in by restructuring them. They typically do so by reducing staff, closing plants, overhauling administration, selling non-core operations and changing internal processes, generally over three to five years. They “exit” by re-listing the company’s shares on the stock market through an initial public offering (IPO) (dubbed “flipping” when it happens so soon after a private buyout) or by selling on to another private equity or strategic investor, or by recapitalising. In recapitalisation, the private equity firm pays itself a special dividend, which is funded more often than not by the acquired company’s borrowings. In 2005, recapitalisation transactions amounted to an estimated \$28.1 billion, the bulk of which were used to pay special dividends to financial sponsors, leaving the portfolio companies loaded with even more debt.

In a nutshell, private equity firms tend to buy companies not to own and run over the long-term (as foreign direct investors such as Siemens or Vodafone might do by investing in a manufacturing plant or telecommunications network), but in order to sell them on at a profit as soon as they can.

Private equity firms have made extensive use of borrowed finance to buy out companies

Private equity often makes tough demands on a company: high returns over a shorter timespan, and extraction of dividends and regular fees

Improving Operational Efficiency on Largest Buyout Deals

Company	Value (\$bn)	Buyer	Year
TXU Corporation	43.8	KKR, TPG Capital, Goldman Sachs	2007
Equity Office Properties Trust	38.9	Blackstone	2007
Hospital Corporation of America	32.7	Bain Capital, KKR, Merrill Lynch	2006
RJR Nabisco	31.1	KKR	1989
Alltel	27.9	TPG, Goldman Sachs	2007
Harrah’s Entertainment	27.4	Apollo, Texas Pacific	2006
First Data	26	KKR	2007
Hilton Hotel	26	Blackstone	2007
Kinder Morgan	21.6	Carlyle, Riverstone	2007
Clear Channel Communications	17.9	Bain, Thomas H. Lee Partners	2008
Freescale Semiconductor	17.6	Blackstone, Carlyle, Permira, Texas Pacific	2006
Albertson’s	17.4	Cerberus	2006
Intelsat	16.6	BC Partners, Silver Lake	2008
Hertz	15	Carlyle, Clayton Bubilier & Rice, Merrill Lynch	2005
TDC	13.9	Apax, Blackstone, KKR, Permira, Providence	2005

Source: Compiled from news reports and industry documents.

Quick Flipping?

Private equity funds' buyout deals are designed primarily to make quick profits through management fees and financial engineering³⁴ rather than through improving the viability of the acquired companies over the longer term. "Buy it, strip it and flip it" is how the general secretary of the UNI trade union network summarised private equity's philosophy.³⁵

Since 2000, some private equity outfits have extracted dividends to the tune of one billion dollars shortly after buying out companies simply by loading them up with additional debt. Take the case of Warner Music Group, one of the world's major record labels, which was bought for \$1.25 billion in 2003 by a group of private equity firms comprising Thomas H. Lee Partners, Bain Capital and Providence Equity. Within months of being acquired, Warner Music made dividends, advisory fees and other payments of \$2.6 billion for its new private equity owners. In other words, the company paid off all the equity originally committed by the buyout group – and more. Yet the promises made by the private equity firms to Warner Music to put the company on a double-digit growth path have yet to be fulfilled. On the contrary, the performance of Warner Music has been deteriorating with no improvement in revenues or profits. The company suffered a loss of \$27 million in the first quarter of 2007 since when its operating revenues have continued to decline. By December 2008, its shares had fallen more than 80 per cent since May 2007.

Just six months after the buyout of rental car company Hertz Corporation for \$15 billion in 2005, a trio of private equity firms collected a \$1 billion dividend, which came entirely from a new loan taken out by Hertz. With the dividend, the trio earned back half their equity investment while keeping their equity stake in Hertz intact. Hertz's debt and interest payments, meanwhile, rose significantly. Similarly, The Blackstone Group put up \$650 million in May 2004 for a part share in Celanese, a US-based chemical company. A scant nine months later, it paid itself \$500 million in dividends in addition to \$45 million netted from Celanese in advisory fees. Another example: private equity firm Thomas H. Lee Partners took over Hawkeye Holdings, a US warehousing and trucking company, in May 2006. Three weeks later, Hawkeye filed registration papers with the US Securities and Exchange Commission to launch an initial public offering, suggesting that not even a pretence was made of restructuring or improving the company.

Some private equity firms have loaded up companies with so much debt that they have bankrupted them. Others knock on the doors of stock markets to bail their companies out. According to Thomson Financial data, 55 per cent of the proceeds from buyout-backed IPOs in 2006 were used to make payments to financial owners and creditors. The corresponding figure for non-buyout-backed IPOs was 21 per cent.³⁶

Unsurprisingly, Moody's Investors Service, the credit rating agency,³⁷ has criticised the private equity industry's claims that listed companies are better off in private hands:

"The current environment does not suggest that private equity firms are investing over a longer-term horizon than do public companies despite not being driven by the pressure to publicly report quarterly earnings."³⁸

The 2007 Moody report states:

"We also question whether there is sufficient evidence to prove

34. Financial engineering creates new financial products or instruments by repackaging existing ones; it often refers to the use of securitisation (see footnote 32), derivatives, hedging and other derivative pricing techniques. Derivatives are assets whose value depends on (or is "derived from") the price of another underlying asset. See Hildyard, N., *A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power*, The Corner House, October 2008, <http://www.thecornerhouse.org.uk/summary.shtml?x=562658>.

35. Speech by Philip Jennings, "UNI Global Union Challenges Private Equity at World Economic Forum", 26 January 2007, <http://www.union-network.org/uniflashes.nsf/40d8481f779124d4c12568db00372009/f8b280d736e74db3c12572a00524bd3?OpenDocument>.

36. Emily Thornton, "Gluttons at the Gate: Private Equity Firms Are Using Slick New Tricks to Gorge on Corporate Assets," *BusinessWeek*, 30 October 2006.

37. A credit rating agency assesses and rates the quality and risk of debt securities, companies, organizations or any project requiring finance before their sale is offered to the public. Ratings are meant to be based on the ability of whoever is requiring finance (and thus issuing a debt) to service that debt and repay the principal and interest at specified dates, such as a mortgage borrower making loan repayments. Ratings are usually expressed as letters (AAA is the top rating) or letters and numbers. The rating is intended to give information to a potential investor about the relative safety of the interest or principal being paid.

Rating agencies are paid for their appraisals, however, by the seller of the debt or the issuer of the security that they rate (who is legally obliged to obtain a rating) not the buyer or investor. Under US law, their rating are deemed "opinions" and protected in law as free speech. Before the sub-prime mortgage market collapsed, almost half the revenue of leading rating agency Moody's came from structured finance involving securitisation ("Fear and loathing, and a hint of hope: Securitisation", *The Economist*, 16 February 2008, pp.81-83).

38. Quoted in Francesco Guerrera and James Politi, "Moody's Slams Private Equity," *Financial Times*, 9 July 2007.

Major Private Equity Trends, 2003–2007

- Private equity funds' share of global mergers and acquisitions (M&As) increased from 4 per cent in 2001 to 25 per cent in 2006 and to more than 35 per cent in the first half of 2007.
- In 2007, the global private equity market witnessed some of the biggest buyout deals ever. KKR and TPG Capital acquired the US-based energy company, Texas Utility, for \$45 billion, while Blackstone took over control of Equity Office Properties in the US for \$39 billion.
- From January–March 2007, more funds were raised globally by private equity than through public share issues.
- Over the past 10 years, private equity has outperformed stock market indices such as Standard & Poor's (S&P) Index, a common benchmark for stock market investments.
- The bulk of private equity fundraising and investments has been based in the US with the UK coming second. Over the years, Europe has also increased its share of fundraising and investments. Some big European private equity firms include Apax Partners, BC Partners, CVC Capital Partners and Permira.
- Private equity funds have been largely investing in manufacturing, healthcare, infrastructure, telecommunications, financial services and property/real estate.
- Development finance institutions such as the World Bank's International Finance Corporation (IFC), the Asian Development Bank and Germany's Investment and Development Company (DEG), are also committing money to private equity funds.

that the higher returns provided to private equity are driven by stronger management teams because, in a benign and liquid credit environment, leverage by itself can provide substantial returns to shareholders.”³⁹

Recent Trends

The period from 2000 to mid-2007 saw low interest rates, a worldwide glut of capital (largely the result of higher saving rates and current account surpluses in Asian countries), buoyant credit markets, rising corporate profits, and a massive growth in structured credit products such as collateralised debt obligations⁴⁰ (see Box: “The Sub-Prime Mortgage Crisis”, pp.14-15) The resulting easy liquidity in the global financial markets nourished a boom in the private equity business. Wealthy investors were encouraged by low interest rates to look for more remunerative investment options. Big institutional investors, such as pension funds, found it preferable to invest in a big private equity fund rather than holding direct stakes in several individual companies that would require daily monitoring at a micro level. Big investment banks, too, entered the private equity business to serve their own commercial interests. Attracted by the advisory fees they would get for arranging deals, particularly leveraged buyouts, they eagerly lent money to private equity funds. In 2006, global investment banks such as Goldman Sachs and JP Morgan Chase picked up \$12.8 billion in fees from private equity firms, and another \$8.4 billion in the first half of 2007 alone. Some investment banks (such as Goldman Sachs) launched new private equity funds to benefit from the boom, while others (such as Citigroup) simply continued to use their own capital to underwrite buyout deals. Often playing multiple (and conflicting) roles of adviser and lender, the banks attracted criticism because of the associated potential for market abuse.

Since 2005, private equity firms relied increasingly on “covenant-lite” loans. These have fewer restrictions and give borrowers greater flexibility about how to structure and repay the debt they take on. In

39. Quoted in Francesco Guerrera and James Politi, “Moody’s Slams Private Equity,” *Financial Times*, 9 July 2007.

40. Structured credit refers to a wide range of financial products that are derived from credit. A Collateralised Debt Obligation (CDO) is a form of structured credit instrument in which a security is backed by or based upon a diversified pool of debt and bonds. A CDO is called a Collateralised Loan Obligation (CLO) or Collateralised Bond Obligation (CBO) if it holds only loans or bonds respectively. CDOs represent different types of debt and credit risk because of the different loans that make up the pool. The exposure to that risk is sold in slices, also known as tranches, each of which has a different maturity and risk associated with it. Tranches are categorized as senior, mezzanine and equity, depending on the degree of credit risk. In case of a default or underperformance, senior tranches (rated AAA) are paid first, followed by mezzanine (rated AA to BB), and lastly equity tranches (unrated). Typically pension funds invest in senior tranches while hedge funds invest in equity tranches.

See also footnote 32; Box: “The Sub-Prime Mortgage Crisis”, pp.14-15; Nicholas Hildyard, *A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power*, The Corner House, October 2008, <http://www.thecornerhouse.org.uk/summary.shtml?x=562658>.

Private equity tends to buy companies so as to sell them at a profit as soon as possible

Lack of transparency is essential to private equity

some cases, the lender is not even allowed to declare a default. Such loans have shifted the balance of power in lending arrangements from banks to private equity firms. According to industry data, four “covenant-lite” loans worth \$2.4 billion were arranged in 2005 in the US, the number jumping to 37 (totalling \$23.6 billion) in 2006 and 104 (with a total value of \$82 billion) in the first half of 2007. After KKR’s proposed buyout of UK retail pharmacy chain Alliance Boots went through in June 2007, the value of “covenant-lite” loan deals in Europe reached \$37 billion.⁴¹

As some of the biggest buyout deals have been beyond the purchasing power of single private equity firms, “club deals” in which a consortium of private equity funds jointly bid for a target company became fashionable. Of the 845 buyout deals completed in 2005, 125 were club deals involving two or more private equity firms. Of the top 10 largest buyout deals (*see* Table: Largest Buyout Deals, p.9.), seven are club deals. These arrangements allow private equity firms to lock up big lenders in exclusive agreements, thereby making it difficult for rival firms to compete for a bid. Given the anti-competitive nature of club deals, national regulatory authorities have become increasingly concerned that private equity funds could be conspiring or colluding to manipulate the purchase price of the target company.

The Buyout Cycle Turns

“It is only when the tide goes out that you know who was swimming naked . . . Well, the tide has gone out – and it has not been a pretty sight.”

*Warren Buffett, US billionaire and investor
2001 Berkshire Hathaway’s Chairman’s Letter*

The private equity industry reached its peak in 2006 when firms got into bidding wars that drove target companies’ prices and premiums to unsustainable heights. Fast forward just two years, and the situation could not be more different. Since June 2007, when sub-prime mortgage lending in the US gradually began to collapse, triggering bank losses worldwide, credit spreads – the difference in yield between different securities based on the quality of their credit – have widened for most investment instruments. In other words, there has been a dramatic “re-pricing” of risk in the credit markets.

The turbulence in the credit markets has negatively affected the global private equity industry, which has largely relied on leveraged finance to acquire companies.⁴² Lenders are demanding tighter conditions on buyout loans, higher interest rates, stricter terms to loan covenants and greater disclosure. The lifeblood of private equity – cheap debt – has all but vanished, meaning that the private equity industry is facing a severe resource crunch of its own.

It will be more difficult and more expensive in future for private equity firms to borrow money for their buyouts, meaning that the Leveraged Buyout model has lost its attractiveness. The markets for Collateralised Debt Obligations (CDOs) and Collateralised Loan Obligations (CLOs)⁴³ (*see* Box: “The Sub-Prime Mortgage Crisis”, pp.14-15)) – both significant ways of obtaining credit – have disappeared and will take a long time to return. Global banking giants (particularly Citigroup, UBS, Merrill Lynch and Credit Suisse) reported huge losses from mid-2007 onwards, when they discovered their exposure to the leveraged loan and sub-prime mortgage markets. By mid-2008, these

41. KKR paid £11 billion to acquire Alliance Boots in June 2007 in Europe’s largest leveraged buyout and the first “take private” of a company included in the Financial Times Stock Exchange (FTSE) 100 index. The deal was finalised just weeks before revelations of the systemic risks in the US sub-prime mortgage market caused global credit liquidity to collapse. The banks that provided £9 billion debt to KKR for the acquisition have as yet been unable to off-load it. Securitisation encouraged banks to agree to grant such loans in the belief that they could quickly get them off their balance sheet.

42. By contrast, strategic corporate buyers such as Siemens and Vodaphone have been less affected because they typically finance their acquisitions from their own cash flows. In fact, the retreat of private equity firms from global buyout markets means less competition for cash-rich strategic buyers who can now acquire firms at lower costs.

43. *See* footnote 40.

four banks alone had announced asset write-downs of almost \$50 billion. In September 2008, Merrill Lynch was bought by Bank of America, while Lehman Brothers went bankrupt. Citigroup is facing hard times because of its higher exposure to buyout loan markets. It announced a write-down of \$1.4 billion on commitments to leveraged buyouts alone. Surprisingly, in the midst of the market turbulence, Citigroup brushed aside concerns over its large exposure to private equity deals and carried on as before. On 10 July 2007, Chuck Prince, then CEO of Citigroup, told the *Financial Times*, “As long as the music is playing, you’ve got to get up and dance. We’re still dancing.”⁴⁴ Just three months later, however, the music had stopped and the party was over.⁴⁵

According to data compiled by Bloomberg, a major source of financial information, the value of announced private equity transactions fell from \$131 billion in June 2007 to \$87 billion in July and down to \$19 billion in August 2007.⁴⁶ Some big private equity firms cannot now pull-off mega-buyout deals because of prevailing credit market conditions and a lack of investor appetite. KKR, for instance, did not pursue a single buyout deal in the US from January to June 2008, compared to several large-scale deals (including a \$44 billion deal for TXU Corporation) in 2007 before the credit crunch hit the markets. Several multi-billion-dollar deals went into limbo or were postponed for several months. In future, the private equity firms will have to offer higher yield on debt and more generous covenants (legal promises about what they will and won’t do).

The credit crunch has not only impacted pending leveraged buyouts, but also negatively affected the portfolio companies of private equity firms. Too much debt has pushed some portfolio companies into bankruptcy or liquidation. For example, Vicorp Restaurants Inc., a US-based restaurant chain operator that owns and operates the Village Inn and Bakers Square restaurants, filed for bankruptcy in April 2008 and plans to close 56 restaurants and related businesses. Wind Point Partners, a US-private equity firm, had acquired Vicorp under a \$225 million leveraged-buyout deal in 2003. In March 2008, another private equity-backed US company, Powermate Corporation, filed for bankruptcy. Some investors in buyout funds, concerned that many private equity-owned companies will simply implode, are selling their commitments in the funds for as little as 30 per cent of their original value.⁴⁷

The bursting of the credit bubble will also affect the Limited Partners who invested in private equity funds who now face meagre returns on their investments. Already the process of de-leverage (paying off existing debts by selling assets quickly) has picked up as some firms try to pull out of the investments they made with borrowed funds. In March 2008, Carlyle Capital, a highly leveraged fund belonging to The Carlyle Group, collapsed when it defaulted on its \$21.7 billion debt. Many more funds are receiving margin calls and default notices from lenders.

Equity markets have also been hit by the turbulence in the credit markets. Investors in equities have felt the chill as takeover premiums offered by buyout firms have almost disappeared. Volatile equity markets make it more difficult for private equity funds to re-sell companies. The “real economy” did not stay insulated from these developments for very long.

In many ways, the credit crunch has broken the popular myth that the boom in private equity is the result of an efficient business model based on superior management skills and “patient capital” that does not expect immediate returns. The private equity business was all about

The private equity business was about debt assembled in a DIY fashion by financiers and aided by governments, central banks and public monetary authorities with supplies of easy money, lax credit controls and tax concessions

44. Quoted in Michiyo Nakamoto and David Wighton, “Citigroup Chief Stays Bullish on Buyouts,” *Financial Times*, 10 July 2007.

45. In October 2007, Citigroup announced a 60 per cent reduction in its income and write-downs of at least \$8 billion in mortgage investment. Prince resigned on 4 November 2007 with a previously-agreed retirement payout of \$40 million. When Merrill Lynch CEO Stan O’Neal was forced to retire in similar circumstances just a few days before Prince, he was paid \$161.5 million.

46. Jason Kelly, “Buyout Firms Could Find it Harder to Make Big Returns,” *International Herald Tribune*, 29 August 2007.

47. Henny Sender, “Rush to Escape Buy-out Funds,” *Financial Times*, 24 November 2008, p.21.

The Sub-Prime Mortgage Crisis

Financial crises occur with increasing regularity, but the unfolding global credit crisis that began in 2007 is far more serious than many of its predecessors. It originated in the US sub-prime housing mortgage market, but soon spread to other developed economies including Germany, the UK and Japan.

The sub-prime crisis was an outcome of booming housing markets in a deregulated financial environment. From 2003 onwards, US housing markets expanded rapidly because interest rates were low. Mortgages to buy homes were pushed on "sub-prime" borrowers – those who do not qualify for market-rate (or prime rate) loans because of their low income or poor credit history. Lenders relaxed their lending criteria for borrowers: loans were sanctioned without proper verification of income and with few checks and balances. In some cases, loans were given to "NINJA" borrowers – "No Income, No Job or Assets". The sub-prime business accounts for some 20–30 per cent of all housing loans in the US.

These loans were not provided out of altruism, but to earn increased profits: the lenders charged sub-prime borrowers higher than usual interest rates and fees. The onus for the resulting credit crisis thus rests primarily with lenders for their predatory lending practices.

The crisis began when the US Federal Reserve raised interest rates that had been as low as 1 per cent to 5.25 per cent between June 2004 and June 2006. Sub-prime borrowers could not meet their increased mortgage payments and defaulted.

Until a few years ago, the financial industry's difficulties stemming from such defaults would have been contained within the United States and limited to the mortgage lender. But the problem has been magnified in depth and breadth across financial institutions, countries and sectors because of "securitisation".

Securitisaton

In the securitisation process, lenders bundle together a number of mortgages and sell them on to a Special Purpose Vehicle, a company usually based in a tax haven. The SPV slices up the bundle (possibly with other loans as well) into tranches (senior, mezzanine or equity), each of which has a different maturity and risk of default or underperformance associated with it. Rating institutions, such as Moody's and Standard & Poor's, rate these tranches on the basis of the quality of the underlying asset (the mortgage repayments): senior tranches are usually rated AAA; mezzanine AA to BB and equity unrated. The SPV then issues and sells Collateralised Debt Obligations (CDO) – securities based on the mortgages – to various investors across the world, including investment banks, hedge funds, insurance companies and pension funds, who buy them so as to receive in return a regular portion of the mortgage repayments. In the case of mortgages, the CDO is called a Residential Mortgage Backed Security (RMBS) – a right to have a share of the amassed mortgage repayments.

The securitisation process enabled mortgage lenders to pass on to others the credit risk of the sub-prime borrowers within days of the mortgages being taken out. With the risks removed so rapidly from their balance sheets, mortgage lenders had little incentive to verify borrowers' credit history.

Securitisation also helped lenders free up capital for more lending, as they no longer had to put money aside to cover the risks of default on these mortgages. Once the risks had disappeared from their balance sheets, the original lending institutions felt that default was now someone else's problem – that of whoever had bought the mortgage or a share in it.

Many investors bought these CDOs because they had received top AAA ratings and had been structured in a manner that offered higher yields. Many failed to realize the risks involved. By June 2007, as interest rates rose and borrowers

began to default, rating agencies downgraded their ratings of CDOs. Suddenly, investors found that they were holding devalued securities that could not be traded at all.

Casualties

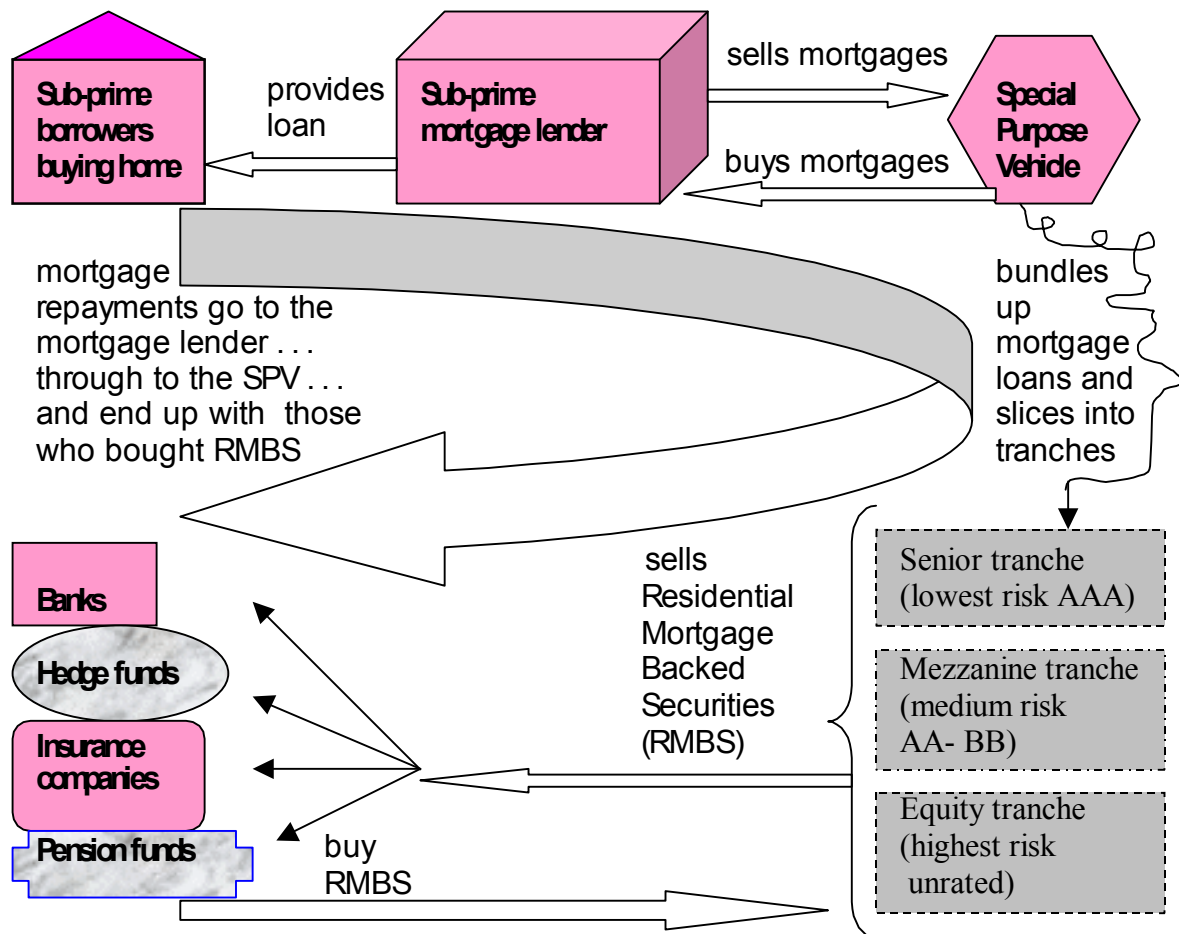
A sharp fall in house prices is now pushing rates of mortgage defaults even higher. Well over two million US homes are expected to be taken away from those who can no longer pay their mortgages, particularly those in lower income groups, and especially Afro-Americans and Hispanics. In addition, a large number of mortgage lenders in the US have closed down and more than 50,000 people have lost their jobs.

Because CDOs were bought worldwide, the sub-prime mortgage crisis spread outside the US. Banks with large exposures to sub-prime mortgage markets have had huge losses, particularly IKB Deutsche Industriebank (Germany), BNP Paribas (France) and Macquarie Bank (Australia). The two US mortgage giants, Freddie Mac and Fannie Mae, have essentially been nationalised. The profits of global banking giants Citigroup, Deutsche Bank, HSBC, Morgan Stanley, Merrill Lynch and UBS have also been badly hit. Merrill Lynch was sold in September 2008 to Bank of America. UBS is considered to be European banking's biggest – and most surprising – casualty of the credit crisis; despite Swiss banks' reputation for reliability, the bank's latest nickname is Used to Be Smart.

Since August 2007, liquidity has dried up in all major markets. In the US, Europe and Japan, central banks intervened to inject liquidity into the global financial system because US and European investment banks no longer wanted to lend money to each other because of the hidden and unknown risks of exposure to CDOs.

Three of the highest profile casualties of the crisis so far have been Northern Rock, Bear Stearns and Lehman Brothers. In September 2007, the UK-based retail bank, Northern Rock, faced a run on its assets when scores of depositors,

The basic securitisation process



fearing that they would lose their life savings, queued up at its branches to withdraw them. This was the first run on a bank in the UK since the collapse of Overend, Gurney and Company in 1866. The run stopped only when the UK government announced a full guarantee of all depositors' money, and effectively nationalised Northern Rock in February 2008.

In March 2008, the US Federal Reserve re-wrote its rule book to rescue Bear Stearns, the fifth largest US investment bank, from collapse on the grounds that it was too entangled with other financial institutions, particularly in credit default and interest rate swaps, to be allowed to fail. Later that month, Bear Stearns was bought by JPMorgan Chase.

In September 2008, however, Lehman Brothers, a larger US

investment bank, was allowed to fail and it filed for bankruptcy, the largest ever seen in the US.

Lessons

Because illiquid securities are not easily valued, no one knows where the sub-prime crisis will end, or its ultimate magnitude. Nevertheless, the disaster raises three important policy lessons. First, in a deregulated financial system, banks and financial institutions can easily indulge in reckless lending to earn fees and quick profits without carrying out "due diligence" on the borrowers.

Second, securitisation has not reduced risk, but merely off-loaded and spread it among other market players through the use of sophisticated techniques.

Third, poorly regulated rating agencies have become a hazard to financial stability. Paid by those whose securities and financial products they assess, they are subject to a crippling conflict of interest that resulted in their giving top ratings to RMBS despite the decline in lending standards and a slowdown in the housing market. Regulating rating agencies will have to move even higher on the policy agenda in 2009 when the Basel II Capital Accord (which sets out how much money banks should set aside to cover the different type of risks and which increases the international financial system's dependence on rating agencies even further) is adopted by all US banks.

The lifeblood of private equity – cheap debt – has all but vanished . . . the private equity industry is facing a resource crunch of its own

debt assembled in a DIY fashion by financiers. Governments, central banks and public monetary authorities chipped in with a supply of easy money, lax credit controls and tax concessions. With the disappearance of cheap debt, the entire private equity industry is facing an imminent slump. The industry's vaunted "better management skills" and "superior structures" failed to protect it.

In many ways, this boom-bust cycle appears similar to the bursting of the leveraged-buyout boom in the early 1990s that ended with many firms collapsing and the economy going into recession. A worldwide glut of capital over the past few years, however, allowed investors to keep moving from one asset class to another, changing business dynamics in the process. The boom-bust cycle is not an aberration but has become an integral part of the present-day global financial system. Private equity has certainly followed this pattern: because most firms' operations are based on excessive leverage, a subsequent decline in their business is only to be expected. This time around, however, the decline will be steeper than any experienced before because of the systemic collapse of the global financial system.

Private Equity Subdued – and Shifting Strategies

"If banks feel they must keep on dancing while the music is playing and that at the end of the party the central bank will make sure everyone gets home safely, then over time the parties will become wilder and wilder."

*Mervyn King, Governor, Bank of England
June 2008⁴⁸*

But the ongoing severe credit crunch does not necessarily imply the end of the private equity business. It could well bounce back from the slump just as it did in the late 1980s and early 1990s. The fact that private equity firms have more financial muscle than they used to, and closer linkages with other global financial actors such as sovereign wealth funds, which are sitting on enormous piles of money, increases their chances of a comeback. Indeed, although the number of buyout deals has slowed to a trickle, the amount of fresh money raised by private equity in the first half of 2008 (US\$323 billion) was almost unchanged from the same period in 2007, suggesting that private equity investors "have been remarkably unfazed" by the credit crunch.⁴⁹

Yet private equity funds are likely to have to change their business strategies and models (and staff with different skills) drastically to overcome the slump. The era of mega-buyout deals is largely over, as the credit squeeze has cut off access to cheap money. Instead, market conditions will favour smaller and middle-market funds that stick to their core competencies and areas of expertise or that focus on acquiring minority stakes in growing companies. The private equity funds of the future are likely to be more specialised and sector-focused. Banks will not and cannot fund mega-buyouts, but may still be willing to make loans for smaller deals below the \$500 million mark.

With an expected rise in corporate defaults as economic conditions worsen, private equity funds may also start picking up more "distressed assets" (loans, mortgages, shares and other types of financial assets that are no longer providing any return). "The stricken banking sector is expected to become a preferred hunting ground for these vulture funds," suggests the *Financial Times*.⁵⁰ The funds may also buy the

48. Quoted in Julia Werdigier, "Britain Moves to Restore Reputation of Libor," *International Herald Tribune*, 10 June 2008.

49. Florian Gimbel, "Buy-out Party is Over But Funds Continue to Flow", *FTfm Financial Times*, 15 September 2008

50. Ibid.

debt (at discounted prices) in their own buyout deal companies as the banks which provided the LBO financing now need to raise capital and are prepared to sell such debt at 70-80 per cent of its face value. Indeed, some of the banks are so desperate to get rid of these loans that they are even lending buyers the money to do so. No one seems to know if it's legal or not for a company to own its own debt.⁵¹ And some private equity funds may put un-invested capital to work by buying up smaller or minority stakes in publicly-listed companies with low valuations, a strategy similar to that pursued by mutual funds.

With big investment banks refusing to make new funding commitments, the private equity industry will reach out to less traditional sources: sovereign wealth funds, hedge funds, public pension funds and mutual funds. The industry has used such funds before as secondary lenders, but is now likely to court them more directly. Big private equity firms such as The Blackstone Group, The Carlyle Group, KKR and TPG have already raised multi-billion-dollar funds from such investors. But while investment banks may provide less leveraged debt finance, they are likely to continue to provide advisory services for substantial fees.

Private equity firms are also likely to shift to less traditional methods of buyout financing, such as integrated and vendor finance (although they may find it difficult to agree to the more passive role required for integrated financing),⁵² and perhaps to try to reduce risk by teaming up with hedge funds and sovereign wealth funds in more "club" buyout deals.

In addition, a major geographical shift may be on the cards if big private equity firms turn to the huge pools of money currently available in the Middle East and Asia. The senior managing partner of Actis, one of the most established private equity investors in "emerging" markets, said in August 2008: "Five years ago no one wanted to do deals in these markets. Now it is the premier league of private equity."⁵³ Some big private equity firms such as KKR, The Carlyle Group and The Blackstone Group have already initiated steps in this direction.⁵⁴ The reasons are obvious. The surge in oil prices in the past five years has created huge current account surpluses in some of these economies, part of which is being made available to their state-owned sovereign

Private equity funds will have to change drastically their business strategies models and staff to overcome the slump

51. Martin Arnold, "Questions Over Sector's Own Debt Purchases", *Financial Times*, 18 August 2008; "Loan Rangers: Private Equity and Banks", *The Economist*, 30 August 2008.

52. Integrated finance is a specialised branch of financing aimed at providing a company with equity and mezzanine financing while underwriting some of the company's "senior debt" (loans that have a higher priority if the company is liquidated). Vendor finance is a loan from Company A to Company B for Company B to buy goods from Company A. By doing this, Company A increases its sales even though it is basically buying its own products. Both integrated and vendor finance provide alternative financing to generate new business.

53. Paul Fletcher, quoted in Martin Arnold, "Reward is Worth Risk for Growth Market Gurus", *Financial Times*, 21 August 2008, <http://www.ft.com/privateequity>.

54. For example, in September 2008, KKR appointed a former Lehman Brothers, Dubai-based banker with experience in liaising with sovereign wealth funds to open a KRR office in the Middle East.

Private Equity and Its Debt

Since the credit crunch started, three broad categories of debt investments involving private equity have emerged, each with different objectives and consequences for investors:

- i) A private equity-owned company buys back its own bank loans at a discount using its own excess cash flow. TDC, the Danish telecoms group owned by KKR, Blackstone, Permira and Providence, bought back €500 million of its own debt in 2008.
- ii) A private equity group provides a company with the cash to buy back its own debt. For example,

Bridgepoint funded a US\$38.7 million purchase by Fat Face, the fashion retailer owned by Bridgepoint, of its debt at a deeply discounted rate.

- iii) The world's largest private equity groups, such as Blackstone, TPG, KKR, Bain Capital and Apollo, have set up separate debt funds to purchase debt. In September 2008, KKR and Permira bought US\$139.5 million of the debt in ProSiebenSat.1, the German television broadcaster, in which KKR and Permira have had a 50.1 per cent controlling equity stake since December 2006.

The Economist gives a hypothetical example of why a private equity

firm might borrow from a bank in order to buy the private equity debt held by that bank:

"[A] bank sells debt with a nominal value of \$10 billion to a private equity firm or consortium for \$8 billion, lending the buyers \$7 billion towards the price. The bank takes a \$2 billion write-down, but reduces its overhang on non-performing debt and gets an additional \$1 billion of equity, moving it one step back towards resuming normal [sic] activities. Meanwhile, the private-equity firm buys debt at a fire-sale price, and will probably end up making a killing".

Source: "All Clear?", *The Economist*, 17 May 2008

The credit crunch has broken the myth that private equity is an efficient business model based on superior management skills and patient capital

wealth funds. The sovereign wealth funds, for their part, are looking for investment opportunities abroad. High Net Worth Individuals (HNWIs) in the Middle East and Asia are another source of funding. Private equity and venture capital investments may also tap Islamic financial institutions that invest exclusively in a Sharia-compliant manner.⁵⁵

Apart from raising money from the Middle East and Asia, the private equity industry is also looking to invest there at a time when US and UK markets are saturated. In the first half of 2008, 104 private equity funds targeting emerging markets were launched, raising US\$35 billion, a 68 per cent increase from the same period in 2007.⁵⁶ Emerging economies, particularly India and China, have been less affected to date by the credit crunch and have enjoyed high economic growth rates, stock market liquidity, political stability, strong corporate performance and a burgeoning middle class.⁵⁷ The United Arab Emirates (a leading financial hub in the Middle East)⁵⁸ and Saudi Arabia (which hosts the Middle East's largest stock exchange) are also attractive to private equity investors. Both countries have the well-developed capital markets that private equity funds need in order to launch an Initial Public Offering when they want to exit from the companies in which they have acquired stakes.

India, China and the Middle East are also likely to see more home-grown private equity funds, which will invest both within and outside the region. For instance, the recently-launched \$500 million Islamic Buyout Fund has received commitments from a Kuwaiti investment company, Global Investment House, and the Dubai Islamic Bank. The two investors join Millennium Capital, an integrated financial services provider based in the Ukraine, as anchor limited partners in the fund, which will invest in Sharia law-compliant private equity deals in the Middle East, North Africa and South East Asia. In the long run, US-based private equity firms are likely to lose their dominant global position to Asian and Middle Eastern private equity firms, sovereign wealth funds and corporate investors.

Moving South: The Indian Experience

Private equity's move to the South accelerates a trend that began even before credit started to dry up in Northern markets. India, as one of the biggest emerging-market centres of private equity investments from 2004 onwards, is a good case study (*see* Box: "Private Equity Trends in India", below).

Returns on private equity investments in India (along with China and other Asian emerging markets) have been much higher than in the US and Europe in recent years. The mind-blowing profits made by the US-based private equity firm Warburg Pincus in an Indian mobile telephone service provider, Bharti Telecom, are a case in point. Warburg Pincus made an investment of \$300 million in Bharti Telecom during 1999-2001 and exited in 2005 with a total return of \$1.92 billion – almost seven times its original investment. Such fabulous profit opportunities have dwindled in US and European markets.

More than 100 private equity firms already operate in India, including some of the biggest firms: The Blackstone Group, The Carlyle Group, Warburg Pincus, KKR, Temasek Holdings (technically a sovereign wealth fund), 3i and Citigroup (*see* Box: "Key Private Equity Players in

55. Finance that is compliant with Sharia (or Islamic religious law) does not charge or pay interest. It does not finance projects that do not comply with Sharia principles, such as investments in gambling, alcohol, tobacco, pornography or speculation. Money can be used, however, to buy goods or services that can be sold on at a profit.

56. Data from the Emerging Markets Private Equity Association, quoted in Phil Davis, "Business Falts as Credit Becomes Scarce", *FTfm Financial Times*, 29 September 2008.

57. Emerging markets whose economies are dominated by exports to the US, Europe and/or Japan, however, may well be affected when demand from these regions declines. *See* Sophia Grene, "Selling out Emerging Markets", *FTfm Financial Times*, 15 September 2008.

58. In March 2006, Dubai Ports World, a company owned by the government of Dubai in the United Arab Emirates, bought the UK shipping and port company (P&O), which also operated six major port facilities in the United States. The outcry in the US about national security and a Middle Eastern government owning key infrastructure led Dubai Ports World to sell P&O's US operations by December 2006 to a New York-based asset management company. Nearly a year later, in November 2007, Dubai Ports World was floated on the Dubai stock exchange in the biggest initial public offering ever in the Middle East in terms of finance raised. There was similar opposition in the US in 2005 when the state-owned China National Offshore Oil Corporation (CNOOC) tried to buy the US oil company Unocal with cash.

India”, pp.26-27). Many big private equity firms treat India as a “key hub” in their Asian investment strategies. Lately, some big private equity firms have also launched specifically India-focused funds. Moreover, most global private equity funds have a substantial number of Indians in their top management teams, who also contribute to the hard sell of India’s growth story.

Meanwhile, India’s home grown private equity firms are raising capital from domestic and foreign institutional investors and investing in a variety of businesses within the country. Some prominent Indian private equity firms include ICICI Ventures, ChrysCapital, IDFC PE, UTI Ventures, Kotak and Sequoia Capital. Some of these home-grown firms are joining with their foreign counterparts to bid jointly for stakes in Indian companies. For example, India’s ChrysCapital joined US-based Providence Equity Partners, the UK-based TA Associates, and US-based Citigroup in taking a 33 per cent stake in Idea Cellular worth \$950 billion.

Although India liberalised its investment regime for private equity back in 1989, it was only during the late 1990s that private equity investors began to show keen interest in the country. At first they concentrated on providing venture capital for start-ups in the information technology sector, which the government was promoting. But in mid-2000, their strategy quickly changed for several reasons.

First, the Indian authorities opened up industry to more foreign investment. Foreign investment limits in the telecoms sector were raised from 49 per cent to 74 per cent, while in the retail sector, 51 per cent foreign direct investment is now allowed in single brand products.⁵⁹ And 100 per cent foreign investment has been allowed in a wide range of infrastructure such as new airports, natural gas pipelines, petroleum infrastructure, mining, toll roads, telecom infrastructure, ports, power generation, Special Economic Zones (SEZs) and townships.⁶⁰ Private equity investors are queuing up to take advantage of the opportunities.

Second, many Indian companies are not listed on the stock markets, and are owned and run by families, thereby providing numerous and easy opportunities for private equity funds to clinch deals directly with company owners. Only 22 per cent of all Indian private equity deals in 2006 were in publicly listed Indian companies, the rest being outside the stock market. In addition, as publicly listed companies have risen sharply in value because of booming stock markets, private equity firms seem to be deliberately avoiding them in order to generate higher returns.

Third, because of increased competition from foreign companies, many Indian companies are ready to exit businesses that do not fit with their strategy for the future, providing an opportunity for private equity firms to come in.

Fourth, some newly-emerged Indian transnational corporations (TNCs) are seeking closer tie-ups with private equity firms in order to benefit from their expertise in fund management and networks. Some Indian corporate houses such as the Ajay Piramal Group and Dalmia Group are also entering the private equity business directly by setting up offshore funds in tax havens, particularly Mauritius, to avoid tax and regulatory oversight and to minimise disclosure of their finances. India’s stock market regulator, the Securities and Exchange Board of India (SEBI), reports that Mauritius-based funds often act purely as a front for private equity firms, the ultimate source of their funds being unverifiable. Since India’s foreign investment regime was liberalised in 2007, the Indian authorities have not screened such investments.

India, China and the Middle East will have more home-grown private equity funds investing within and outside the region

US-based private equity firms are likely to lose their dominant global position to Asian and Middle Eastern private equity firms, sovereign wealth funds and corporate investors

59. This means that fashion shoe retail companies such as Jimmy Choo, for example, can set up shop in India, but large retailers, such as Tesco, that sell many different brands and products are not allowed.

60. Townships in India are small, self-contained residential suburbs with their own private supply of power, water, security, roads and other infrastructure designed for middle and upper-class inhabitants.

Private Equity Trends in India

- Private equity investments in India jumped from \$2.2 billion in 2005 to \$17 billion in 2007.
- Private equity inflows to India have grown at a compounded annual rate of 67 per cent since 2002.
- In 2006, private equity investments (\$7.4 billion) became the single largest investment class driving mergers and acquisitions (M&A) in India, overtaking both foreign (\$5.4 billion) and domestic (\$4.99 billion) strategic M&A investments.
- India now ranks first in Asia in terms of private equity mergers and acquisitions.
- India was the third largest destination (after Australia and Taiwan) for private equity investments in the Asia-Pacific region in 2007, both in terms of value and volume of investments.
- India accounted for more than half of all private equity inflows into BRIC (Brazil, Russia, India and China) countries in 2007 and topped the private equity deals list for these countries.
- India-focused funds managed by both foreign and domestic private equity firms increased from an average \$100 million in 2003 to between \$400 million and \$1 billion in 2007.
- Multi-million dollar deals are becoming common, although India has yet to witness a single billion-dollar private equity investment.
- The average private equity deal in India now starts at around \$25 million, up from \$8 million in 2002.
- The Manila-based Asian Development Bank has been actively involved in Indian private equity markets since 2004. It has invested in India-focused private equity funds such as IDFC and Baring.

Returns on private equity investments in India, China and other Asian markets have been much higher than in the US and Europe in recent years

Private equity investments are considered as foreign direct investment (FDI) in India, which is misleading. Private equity investors, unlike foreign direct investors, do not bring technology and usually have a short-term investment horizon. Moreover, since private equity investments generally constitute less than 10 per cent of a company's capital, they should be treated as portfolio investments.

Due to their political patronage by members of the Indian establishment, private equity funds have remained largely unregulated in India. The Indian authorities have not even collected credible data and information about the sectors and firms in which private equity funds are investing. Much of the information that is available is sourced from private data firms.

Private equity investments in India have shifted among sectors over the years. Of late, infrastructure, real estate, banking and financial services, media and entertainment sectors have attracted more interest than traditional sectors such as information technology, information technology-enabled services (such as medical transcription, back-office accounting and insurance claims), pharmaceuticals and telecoms.

Growth Deals Dominate Instead of Buy-Outs

Global private equity funds adopt different strategies in India than in Europe and the US. While in Europe and the US, private equity has been equated with leveraged buyouts, in India it tends to involve acquiring minority stakes in growing companies without taking over their management. Such "growth deals" account for over 80 per cent of all private equity transactions in India; buyout deals have so far not been substantial (although the buyout market is evolving).

There are several reasons for the difference. First, most domestic businesses in India that have received private equity investments are just developing and are eager for quick equity capital to expand and sustain high growth. Such businesses have been mainly in the infrastructure, financial services, logistics and construction sectors, which are growing at a rate of 20 per cent or more annually. In contrast, leveraged buyouts typically flourish in businesses with flat growth rates.

Second, growing companies have fewer opportunities to restructure their operations by selling parts of the business. Third, few businesses in their growth phases are for sale in their entirety – owners and promoters are willing to hive off only minority stakes to outside investors. Fourth, domestic debt markets in India are not deep enough to finance complex leveraged buyouts. Fifth, existing labour and competition policy regulations in India prevent complete closures and asset-stripping by private equity funds.

In addition, the exit returns from growth deals are potentially huge, as witnessed in the case of Warburg Pincus's exit from Bharti Tele-ventures in 2005 (*see* p.18). According to data firm Venture Intelligence, private equity and venture capital funds exited from 160 companies either through Initial Public Offerings (IPOs) or Mergers and Acquisitions (M&As) between 2004 and the first half of 2007. While an IPO is the preferred exit route, private equity-to-private equity deals are also taking place in India. The purchase of OCM Textiles by Wilbur Ross from Asset Reconstruction Company of India (Arcil) in 2006 is an example. In such deals, the Indian promoters have no control over the choice of the new private equity investor. From the perspective of a General Partner in a private equity fund, moreover, growth deals are as lucrative as buyouts. Even when private equity funds do not generate profits from such deals, the General Partner can still earn substantial management fees.

Growth deals are likely to continue in India in the near term with buyouts remaining the exception. But buyout deals may come to overshadow them if the country's economic policy and regulatory regime are liberalised further in the coming years. Indeed, a number of small-to medium-sized buyout deals have been announced since 2006. KKR's acquisition of 85 per cent of Flextronics Software Systems and Blackstone's buyout of Gokuldas Exports Limited are illustrative of what might be an emerging trend.

Although growth deals appear less destructive than LBOs, they are still controversial in India. In 2003, for example, Actis, a UK-based private equity firm whose largest investor is the UK government,⁶¹ paid \$60 million for 29 per cent of equity in the state-owned Punjab Tractors Limited (PTL), the country's first private equity-backed privatization deal. Although Actis's subsequent attempt to restructure PTL's operations was opposed by PTL's senior management, Actis managed to oust the entire senior management team (including the chair) in 2006 when it brought an Indian shareholder onto the board. In early 2007, Actis sold its 29 per cent stake to a strategic investor, Mahindra & Mahindra Limited, for \$144 million. In other words, within three years, Actis had cornered a handsome profit of about 2.4 times its initial investment.

Deals involving the selling of publicly-traded shares to private investors are also a significant feature of the Indian landscape, accounting for an estimated 21 per cent of all private equity investments. In these PIPE – Private Investment in Public Equity – deals, private equity firms buy a large chunk of the stock of publicly-listed firms, usually at a discount, and then look to expand the business along with the existing management. In some rare instances, private equity investors have bought a controlling stake and changed the management of the company. PIPE deals are considered useful for small- and medium-sized companies that typically have a difficult time accessing traditional forms of equity financing, and are popular when the stock markets are in panic.

Instead of making leveraged buyouts, private equity in India acquires minority stakes in growing companies without taking over their management

...

... but buyout deals may overshadow growth deals if India's economic policy and regulatory regime are liberalised further

61. Actis was spun off as a management buyout from the UK government's Commonwealth Development Corporation (CDC) in 2004, with CDC remaining its largest investor. The firm announced in December 2008 that it had raised US\$2.9 billion for a new private equity fund to invest in companies across Africa, China, India, Latin America and South-East Asia, indicating that emerging market private equity groups could still raise cash while those in the US and Europe could not. CDC put US\$650 million into the new fund.

Bullish on Infrastructure

62. Sheoli Pargal, "Concession for the Delhi Noida Bridge," Planning Commission, New Delhi, August 2007, <http://infrastructure.gov.in/pdf/NOIDA.pdf>.

Although private investors are usually reluctant to fund infrastructure projects because of the high initial capital costs, relatively long gestation periods and delayed returns, private equity firms have moved into Indian infrastructure in a big way. Investments in Indian infrastructure

Delhi–Noida Flyway: A Flawed PPP Model

Despite their popularity within government and business circles, private–public partnerships (PPPs) have remained highly controversial in India because projects offer almost guaranteed returns, lower political and regulatory risks, and assured usage of services. The Delhi–Noida bridge project, which is often touted as a PPP "pioneer" in India, is a case in point.

Commissioned in 2001, the 552–metre–long toll bridge (popularly known as the DND Flyway) connects the Indian capital, Delhi, with Noida, one of its more modern suburbs and an industrially developed area. The project was promoted by Infrastructure Leasing and Financial Services Limited (IL&FS), which established the Noida Toll Bridge Company Limited as a Special Purpose Vehicle (SPV) to construct, operate and maintain the Delhi–Noida bridge on a Build, Operate, Own and Transfer (BOOT) basis.

IL&FS shareholders over the years have included leading domestic and international institutions such as the Central Bank of India, Housing Development Finance Corporation (HDFC), ORIX Corporation (Japan), Credit Commercial de France, Abu Dhabi Investment Authority and the World Bank's International Finance Corporation (IFC).

The Delhi–Noida bridge project was also the first infrastructure project in India to receive private equity funding: the AIG Indian Sectoral Equity Fund (sponsored by American International Group) invested in it in 1996 and exited through an IPO in 2001.

The Noida Toll Bridge Company is listed on Indian stock exchanges while its global depository receipts are listed on the Alternative Investment

Market (AIM) of the London Stock Exchange. Finance for the project was structured on the basis of a 30–year concession with a 70:30 debt–equity ratio.

A concession agreement was signed in 1998 between the Company (the concessionaire), IL&FS, the New Okhla Industrial Development Authority (NOIDA) and the government of Uttar Pradesh. The concession agreement shows clearly that the terms and conditions disproportionately favour the private partner, while all the risks are shouldered by the public authorities. A recent study carried out by a consultant with India's Planning Commission pointed out several objectionable clauses that "weigh the contract in favor of the private partner and that, from a public policy viewpoint, depart from best–practice contract design".⁶²

- The concessionaire gets guaranteed returns of 20 per cent per annum of the total cost of the project, not of its equity. Any shortfall in returns because of a drop in toll revenues is added on to the total cost of the project. Toll revenues did fall in the initial years, as expected, resulting in the capital costs doubling from Rs. 4,080 million (US\$82 million) in 2001 to Rs. 9,530 million (US\$190 million) in 2006.
- The 30–year concession can be extended until the concessionaire has recovered all its costs, up to a maximum of 70 years.
- The concessionaire was granted development rights over 30 acres of prime urban land on the NOIDA territory.
- The agreement does not provide any incentive to minimise operational costs. On the contrary, there is a perverse incentive to inflate the costs as any increase in the total project

cost automatically leads to higher returns to the concessionaire.

- Typically, user fees on infrastructure facilities are determined by state authorities, but this concession agreement allows the private partner alone to determine the toll tariff.
- The concessionaire does not bear any of the risks of not finishing construction, insufficient traffic or any other commercial risk because its returns are guaranteed by its rights to extend the concession period or to raise the toll tariff or to develop its land in the NOIDA territory. Further, there are no penalties if the concessionaire does not follow performance standards.
- NOIDA undertook not to build a competing bridge for 10 years or until the DND Flyway reaches its Full Rated Capacity (defined as 16,000 passenger car units during a peak hour), whichever is later. There was no competitive bidding for the project. Besides being a project sponsor, IL&FS was also a member of the Steering Committee deciding that the project would be implemented by the IL&FS company, a clear potential conflict of interest.
- If NOIDA terminates the agreement, it will have to pay the concessionaire an amount equal to the total project cost and 20 per cent returns until the termination date.

Similar clauses have been incorporated in several PPPs in India. According to government sources, 86 PPPs had been awarded as of December 2006, most of them related to roads and ports.

have been more profitable than in other Southern countries, yielding an average internal rate of return (IRR) of about 25 per cent compared to 15 per cent in other sectors such as textiles and clothing. Tax incentives in the form of government guarantees, interest subsidies, duty-free imports of capital goods, capital grants and tax holidays on the profits add to the attraction. For instance, a tax holiday of up to seven years is available for companies setting up ultra-mega power projects (UMPPs).⁶³ Venture capital and private equity funds have also been offered “pass-through” status in the power sector, enabling them to avoid tax on the profits they earn when they exit from unlisted firms.

The Indian government’s preferred model for financing infrastructure is through Private-Public Partnerships (PPPs), in which contracts are drawn up between governmental or public authorities and private sector entities. Special Economic Zones (SEZs) have been developed on this model, as well as freight corridors between the country’s capital, Delhi, in the north of the country, and Mumbai, India’s business and financial capital on its Western coast, and modernised airports in these two cities. Most roads and bridges are being constructed on a build, operate, transfer (BOT) or build, operate, own and transfer (BOOT) basis. Where PPP projects are not self-financing, the Indian government offers to fill up to 40 per cent of the “viability gap”. Investors are therefore able to evade much of the risk customarily associated with large infrastructure projects.

Private equity firms have also found Indian infrastructure investments attractive because of a huge gap between supply and demand. India reportedly needs to generate an additional 70,000 MW to meet its growing energy requirements. The government’s Planning Commission estimates that the country needs \$350 billion in infrastructure investments by the year 2012. Such huge sums cannot be supplied from the government’s budget alone, particularly given India’s deteriorating fiscal position. If one assumes a debt-equity ratio of 70:30, then about \$250 billion of debt and \$100 billion of equity needs to be raised by the year 2012. It has been estimated that 25 per cent of the total equity (\$25 billion) can be raised from the private sector, particularly private equity players, through direct and indirect investments, leaving 75 per cent to be supplied by the government. Private equity has been further encouraged by a lucrative global trend toward increased private-sector infrastructure financing; the \$6 billion Millennium Fund managed by KKR, for instance, delivered annual returns of 55 per cent since being launched in 2000.

Private equity funds, however, do not directly finance specific infrastructure projects in India, as the World Bank or a private finance company would typically do. Rather, they invest in a holding company, which in turn invests in the projects. This portfolio approach has the advantage of diffusing the risks associated with infrastructure projects. It also bypasses capital controls on foreign investments and allows private equity funds to exit more easily by selling their equity on to other investors. In addition, since holding companies can issue IPOs in stock markets more easily than a specific infrastructure company, the approach frees up finance for future infrastructure investments.

Thus in 2007, major private equity firms Blackstone and Citigroup launched the India Infrastructure Financing Initiative, which will set up a \$5 billion fund to finance infrastructure projects in the country. The Initiative will be managed by the Infrastructure Development Finance Corporation of India (IDFC), a state-owned specialised financial intermediary that finances almost one quarter of the country’s private

Investments in Indian infrastructure have been very profitable, aided by government guarantees, interest subsidies, duty-free imports of capital goods, capital grants and tax holidays

Private equity’s portfolio approach to infrastructure financing bypasses capital controls on foreign investments

63. The Indian government plans to set up 12 UMPPs in India – large projects of approximately 4,000 MW each that would supply power to a number of power distribution entities located in different States. They are being developed on a Build, Own and Operate (BOO) basis. The proposals, based on fossil fuels, have alerted environmental groups, which are raising concerns about emissions levels and the impacts on climate change and global warming.

Speculation has driven India's real estate growth above that of the country's overall economic growth

sector-focused infrastructure projects. Of the \$5 billion fund, \$2 billion will be in the form of equity and the rest raised through debt. Blackstone and Citigroup have each committed themselves to invest \$75 million in the Initiative's equity component. Some years back, IDFC launched its own private equity firm, IDFC Private Equity, which manages an infrastructure-focused fund of \$636 million.

Likewise, the UK-based 3i Group has joined hands with the India Infrastructure Finance Company Limited (IIFCL) – a finance company wholly-owned by the government of India – to raise another \$5 billion to invest in a range of infrastructure projects, especially power plants, ports, logistics, airports and roads. The 3i Group launched a 3i India Infrastructure Fund with a target of \$1 billion in 2007, the first billion-dollar infrastructure fund launched by a foreign private equity investor. The private equity firm will invest \$250 million while the rest of the money will be raised from multilateral financial institutions and private banks. The debt raised by IIFCL would be fully guaranteed by the Indian government. The 3i Group has already invested in a number of infrastructure companies in India, including Vijai Electricals India (a power equipment maker) and Gujarat Adani Port (a port operator).

JP Morgan has similarly invested in a holding company, Larsen & Toubro (L&T), to manage its infrastructure assets in the country. Interestingly, L&T is planning to raise its own \$1 billion private equity fund. Meanwhile, Citigroup Venture Capital International (managed by Citigroup) has invested \$60 million in Indo-Barath Power Infra Limited, a holding company of the Indo-Barath Group that runs captive power plants (both hydro- and coal-based) for big manufacturing companies in India. Private equity funds are also showing a growing appetite for infrastructure in Special Economic Zones (SEZ), which are controversial in India because of the special tax, legal and other concessions extended to them. SEZs have been portrayed as engaging in the process of “accumulation by dispossession”.⁶⁴

Jumping on the Property Bandwagon

Private equity funds are also investing aggressively in real estate development companies, particularly since property was opened to foreign investment in 2005. Industry sources estimate that private equity investments in property will reach \$7 billion by 2010. Some of the major domestic and foreign private equity firms active in real estate include Warbus Pincus, ICICI Ventures and IL&FS Investment Managers. US-based Trikona Capital, an India-focused real estate fund, plans to invest around \$10 billion over the next 10 years in a range of real estate projects from slum development projects in Mumbai to a Special Economic Zone (SEZ) in Haryana, the state in northern India that surrounds Delhi.

Residential properties have become attractive partly due to the enactment of India's Securities Contracts (Regulation) Amendment Act 2007, which provides a legal framework for the listing and trading of securitised debt instruments. Integrated townships are favourite investor targets. Commercial property is also experiencing a boom due to high demand for office space from retail, biotechnology, telecoms, pharmaceuticals and financial services firms – a demand further enhanced by the growth in the outsourcing of tasks such as information technology services, medical transcription, back-office accounting and insurance claim processing.

Thanks to speculation, the real estate sector in India has been growing

64. Swapna Banerjee-Guha, “Space Relations of Capital and Significance of New Economic Enclaves: SEZs in India”, *Economic and Political Weekly*, 22 November 2008.

at a faster rate than the country's overall economy. The returns in certain cities such as Bangalore and Delhi are among the highest in the world. Overall returns in India have been close to 30 per cent, compared to a global average of 5.5 per cent. In the words of Aashish Kalra, Managing Director of Trikona Capital:

“When we underwrite a deal, we expect an internal rate of return of 25 per cent. In deals where we are involved [in India] from the early development stage, it would be in the region of 35-40 per cent.”⁶⁵

Because domestic real estate companies have a shallow equity base, they are unable by themselves to meet the growing demand, particularly for residential properties, spurred on by urbanisation and the rising living standards of the aspiring middle and upper classes.

Close to 95 per cent of private equity funds use Special Purpose Vehicles (SPV) to invest in real estate projects in India so as to bypass the three-year mandatory lock-in regulation applicable on foreign investments in the real estate sector. Routing their investments through an SPV (usually incorporated in Mauritius) makes it possible for the funds to sell their exposure to another private equity investor at any time, or even sell the SPV itself.

The Lure of Financial Services

In the first half of 2007, some of the biggest private equity investments in India were in the financial sector, particularly in banking and financial services. Given that the banking sector has not yet been fully opened for foreign investments, this suggests that private equity investors see great speculative value here.

India's financial sector shows tremendous potential for growth. As yet, the country has only 22 million credit cardholders, as against 200 million mobile phone subscribers. Housing mortgages have a mere 6 per cent share of GDP compared to 11 per cent in China. Household savings invested in financial products represent a mere 18 per cent of GDP. At the same time, India has been creating millionaires faster than any other country in the world, thanks to its booming stock markets. According to the *World Wealth Report 2008*, India had the most High Net Worth Individuals (HNWI), their population growth rate a stunning 22.7 per cent a year, driven largely by market capitalization growth – the country's booming stock markets – and real GDP growth of 7.9 per cent.⁶⁶ India added another 23,000 millionaires in 2007 to its 2006 tally of 100,000, each holding at least \$1 million in financial assets (excluding their primary residences and consumables). As the newly wealthy grapple with their riches, wealth management and advisory services have boomed. Furthermore, the country's demographics (60 per cent of India's population is below 30 years old) offers the prospect of greater spending power in the hands of working youngsters. All these statistics, combined with the country's large-scale infrastructure and real estate growth, suggest a huge potential for financial products and services.

Already, the stockbroking industry in India is doing a roaring trade, boosted by the sharp rise in the daily turnover of stock markets in the past two years – the Indian share market has surpassed \$1 trillion in market capitalization and the “commission” market is growing at 30 per cent a year. Stock markets are likely to expand still further as a result of reforms allowing greater involvement by pension funds. This is

Some of the biggest private equity speculative investments in India have been in banking and financial services

65. Quoted in Vatsala Kamat and Mobis Philipose, “PE in Realty: Shrewd Targeting,” *BusinessWorld*, 14 May 2007.

66. *World Wealth Report 2008*, Capgemini and Merrill Lynch, 2008. <http://www.uscapgemini.com/worldwealthreport08/>

enticing news for overseas private equity investors because, unlike for banks, there are foreign ownership restrictions on brokers. Private equity firms are particularly interested in institutional broking and Mergers and Acquisitions (M&A) advisory services.

India already has small, family-run broking companies that provide a range of financial services involving insurance, real estate, the art market and structured products. But the capital intensity of stockbroking means that if such firms want to expand, they must either float in an IPO or seek investment from private equity funds. Prominent domestic broking firms such as JM Financial, Sharekhan and Motilal Oswal have gone the latter route. In July 2007, JRG Securities sold a 45 per cent stake in its business to Baring Private Equity Partners India for \$35 million, making Baring the single largest shareholder. This was the eighth such investment in the broking business by private equity funds in India in 2007, compared to just three in 2006. In the coming years, the expansion of the broking business is likely to be driven in part by the creation of new India-specific funds by foreign institutional investors and hedge funds.

Key Private Equity

It is difficult to get a true picture of private equity's investments and operations in India because of the high level of secrecy that firms maintain. Information available in the public domain, however, is enough for a sketch to be drawn of six firms active in Indian markets.

Temasek Holdings

(www.temasekholdings.com.sg) is the sovereign wealth fund fully owned by the Singapore government. With a global investment portfolio of over \$100 billion, Temasek started its Indian operations in 2004 out of an office in the country's financial capital, Mumbai, on India's west Coast. Although Indian investments accounted for just 3 per cent of its portfolio in 2006, Temasek wants to increase its exposure to Indian and other Asian markets. Industry sources claim that Temasek has invested in excess of \$3 billion in India since 2005. In 2007, Temasek voluntarily released its annual financial review, which reveals that it has earned returns of more than 18 per cent compounded annually. Such attractive returns have disproved sceptics who had predicted lower returns and bureaucratic shackles because of Temasek's state ownership.

Temasek's most prominent

deals in India include an 8 per cent stake in ICICI Bank, an indirect stake of 4.99 per cent in Bharti Airtel, and 9.7 per cent in Tata Teleservices. It has also invested in many premier Indian companies, such as Mahindra & Mahindra, Tata Sky and Inx Media Ltd.

Temasek has also maintained a successful record of exits. In August 2006, for instance, it sold its equity in Matrix Laboratories to Mylan Labs for \$736 million.

Temasek also invests in India through a fund of private equity funds, which gives it access to a much broader range of Indian companies (although it has not made public information about its fund of funds investments).

The Carlyle Group

(www.carlyle.com), a US-based private equity firm, has been investing in India since 2000, but its large-scale investments picked up only in the last couple of years. Carlyle's Indian investment portfolio is part of its Asia focused funds. Through Carlyle Asia Partners II fund, the firm picked up 5.6 per cent equity worth \$650 million through a preferential allotment in India's largest housing finance company, Housing Development Finance Corporation Limited (HDFC) in May 2007. While earlier investments made by Carlyle were restricted to private companies, its stake in HDFC suggests that the

private equity firm is keen to undertake big deals in India through PIPE (private investment in public enterprises) transactions. India remains one of the key markets for investments for its \$680 million Asia Growth Partners III fund. The funds managed by Carlyle undertake both growth and buyout deals in India.

The Blackstone Group

(www.blackstone.com), headquartered in New York is a late entrant in the Indian markets. It set up its office, Blackstone Advisors India Private Ltd, only in 2005 with a \$1 billion investment fund. More recently, it has been more active in the Indian markets, particularly after its successful \$4 billion initial public offering on the New York Stock Exchange. In less than a year, Blackstone undertook five deals worth \$840 million in a range of Indian companies, including two buyouts. "Money is not an issue," claims Akhil Gupta, Managing Director of Blackstone Advisors India Pvt. Ltd.ⁱ

Blackstone's investment pattern in India indicates that the firm is more inclined towards buyout deals, evidenced by its August 2007 buyout of Gokaldas Exports Limited (GEL), the first buyout of a publicly listed firm in India. This deal gives Blackstone

Private equity investors are also looking at microcredit institutions, which have mushroomed in recent years and attracted interest from big banks (such as Citibank and ABN Amro) and hedge funds, partly because they are as yet unregulated. Private equity firms Aavishaar Goodwell, Legatum Capital and Sequoia have already invested in a range of microcredit delivery institutions in India. Microcredit investments are expected to accelerate in the coming years for two main reasons. First, the sector has the potential to provide extraordinary returns: some microcredit institutions charge borrowers annual interest rates of 80 per cent or more. Second, the microcredit sector is not considered sensitive to swings in global economic cycles, making it useful for diversifying investment risks.

Any surge of investment in microcredit institutions, however, may lead to aggressive lending, with potentially negative consequences. In the southern Indian state of Andhra Pradesh in 2005, the easy availability of microcredit led many borrowers to take on more debt than they could afford, even though there was little difference between the rate charged by a microcredit institution and that by a traditional money-

Players in India

control over 46 garment manufacturing facilities across India with 46,000 employees, capable of producing 2.5 million pieces of clothing a month. Some internationally popular brands such as GAP, Nike and Reebok are GEL customers. NGOs have documented large-scale violations of workers' rights, especially of women employees, at GEL's Bangalore-based factories.

Like many other big private equity players, Blackstone is also keen on infrastructure investment in India. It has joined hands with the Infrastructure Development Finance Corporation of India and US investment bank Citigroup to launch a \$5 billion infrastructure fund promoted by the government-backed India Infrastructure Finance Company.

Blackstone also made a \$65 million equity investment in November 2007 in MTAR Technologies, a nuclear and space science component manufacturing company. This is the first private equity investment in India's defence and nuclear sector. MTAR Technologies has often been in the news because it faced US sanctions after India conducted nuclear tests in 1998.

ChrysCapital (www.chryscapital.com) started out as a venture capital firm in 1999. It now manages over \$2.2 billion across five funds and claims

to be the largest India-focused private equity fund. It recently launched a \$1.25 billion India-focused fund that has received capital from the US, UK and Asia with a holding period of over four years.

ChrysCapital focuses on diverse sectors such as business services, consumer goods and services, financial services, infrastructure, manufacturing, healthcare and pharmaceuticals.

Some important investments into Indian companies include Idea Cellular, Mphasis, Spectramind, Suzlon, Moser Baer, Yes Bank, ING Vyasa Bank and Axis Bank. In terms of its investment strategy, ChrysCapital invests in both growth capital and buyouts with an equity investment range of \$30–\$300 million. Apart from co-investing with other private equity firms, the firm is considering partnering with Indian companies for acquisitions abroad.

ICICI Ventures (www.iciciventures.com), is the largest home-grown private equity firm with funds under management in excess of \$2 billion and a target of \$10 billion assets under management by 2010. Most of its investments are related to buyouts and mezzanine financing. The firm raises money largely from domestic and international investors. Infrastructure and real estate are

its focus areas. In 2008, it launched a \$3 billion infrastructure fund to invest in road, port and power projects across the country. One of its recent investments was in Jaypee Infratech, which is implementing the Taj Expressway, a 165-kilometre toll road in the northern state of Uttar Pradesh from Noida to Agra.

3i Group (www.3i.com), a long-standing UK-based private equity firm, entered the Indian market in 2005 and has invested over \$500 million in India across 12 firms, mostly in the form of minority stake and growth investments. In April 2007, it launched an India-dedicated infrastructure fund in partnership with the government-backed India Infrastructure Finance Co. Ltd. (IIFCL). The fund has already invested \$227 million in Adani Power, a 100 per cent auxiliary company of Adani Enterprises Ltd. Adani Power is building a 2,640 MW imported coal-based power plant in Gujarat (expected to be operational by 2010) and has also proposed a 2,000 MW coal-based power plant in Maharashtra.

ⁱ Quoted in Vatsala Kamat and Mobis Philipose, "PE in Realty: Shrewd Targeting," *BusinessWorld*, 14 May 2007

Key questions on private equity's infrastructure investment are: Infrastructure for whom? Who pays? Who benefits?

lender (100 per cent and above). Some microcredit institutions have used humiliation and coercion to recover their loans, including making women (the majority of the borrowers) stand in the hot sun, locking them out of their homes and even advising them to commit suicide. Official data indicates that 60 borrowers committed suicide in Andhra Pradesh after they were harassed by microcredit institutions.⁶⁷

For the future, the Reserve Bank of India, the country's central bank, has announced a two-phase programme to pave the way for the entry of foreign players into the Indian banking sector. During the first phase between March 2005 and March 2009, foreign banks will be permitted to establish a presence in India by setting up a wholly owned subsidiary (WOS) or by converting existing branches into a WOS. In the second phase, due to start in April 2009, foreign banks will be accorded "National Treatment" – they will be treated as if they were domestic banks and any remaining restrictions on foreign control (including the 10 per cent ceiling on voting rights) will be eliminated. A full liberalization of India's capital account⁶⁸ would clear the way for even more foreign investments in banking and financial services.

India and the Future of Private Equity

"I am probably the only private equity investor who says that the returns [in India] are way too high. We make a lot more money in India than we should. We need to learn to appreciate risk-adjusted returns. Everyone here speaks in terms of absolute returns. Making 25 per cent with less than 30 per cent debt is very different from making 25 per cent return with 80 per cent debt and 10 per cent mezzanine (finance). Across projects, we are making 20-30 per cent [returns], but all the profits we are making with less than 20-30 per cent debt."

Aashish Kalra, Managing Director, Trikona Capital⁶⁹

The slump in the private equity business in the US and Europe has not yet had a major negative impact in India. On the contrary, the volatility of the Indian stock markets in the aftermath of the global credit squeeze could turn out to be a blessing in disguise for private equity firms since the market turmoil has significantly brought down the valuations of Indian companies. As a result, economic opportunities for private equity funds in India could expand further. Moreover, many global private equity firms have already established India-dedicated funds that cannot invest elsewhere, with long-term investments from pension funds and university endowments.

While 90 per cent of the private equity investment coming to India is currently from the US and Europe, this proportion will wane in coming years as private equity investors from West and South-East Asia make inroads. With the rise of investment protectionism in some Western countries, private equity investors from West Asia are now investing directly in India, channelling money that used to go through Western banks such as UBS, Credit Suisse and Morgan Stanley. West Asian private equity funds currently active in India include Baer Capital, Dubai Ventures, Evolve India fund and Sabre Abraaj. West Asia also represents the biggest single source of funds-of-funds investment in India. Investors from Japan (for example, Japan Alternative Investment Company) and Malaysia (such as Khazanah Nasional Berhad) have shown interest in the Indian private equity markets as well. Asia-based

67. International financial institutions and aid donors have long provided grants, loans and training to microcredit organizations that now number some 10,000 worldwide. Anand, "High Cost of Finance in Microcredit Business in Andhra Pradesh (India): Problems and Possible Solutions", *The Icfai Journal of Management Research*, Vol. 7, No. 4, April 2008, pp.41-62.

68. The capital account in a country's balance of payments includes a variety of financial flows – mainly foreign direct investment (FDI), portfolio flows (including investment in equities), and bank borrowing. These flows can be controlled to some extent by placing restrictions on them when they pass through official channels. Capital account liberalisation refers broadly to the easing of restrictions on capital inflows and outflows. A country's current account is the other primary component of its balance of payments. The current account is the difference between a nation's exports and imports of goods and services. At present, India has liberalised only its current account, not its capital account.

69. Quoted in Gayatri Ramanathan, "I'm the Only PE Investor Who Says Returns Are Way Too High", *Mint*, 3 August 2007.

Limited Partners contributed 70 per cent of IDFC Private Equity's second fund, which raised a total of \$440 million.

Many private equity funds are following India-based mutual funds and state-owned corporations in taking an interest in natural resources. For example, Origo Sino India is seeking to raise \$100 million for a proposed fund to invest in companies operating in iron ore, mining, forestry, renewable energy and related sectors.

Private Equity's Vulnerabilities

"Suspicion lingers that private equity firms are just asset-strippers in pin-striped suits."

*The Economist*⁷⁰

Even before the credit crunch, the operations of private equity firms had come under closer public scrutiny in the US and the UK. Current concerns include, above all, lack of transparency and low rates of taxation. If the public can be mobilised, other problems such as job losses, market abuse and the excessive use of leverage may also come under the spotlight.

▪ Lack of Transparency and Disclosure

Finding out what private equity firms are up to is nigh on impossible. Unlike publicly listed companies, which are legally bound to disclose certain business information and practices, private equity firms do not have to release any data about their operations or those of the companies in which they invest and buy. This is not to suggest that publicly listed companies are transparent and voluntarily share information with the public at large. But certain information about their operations, such as remuneration paid to executives or major legal cases being taken against them, is in the public domain, and for almost two decades, campaign groups and institutional investors have been able to use shareholder activism to seek out more information from publicly-listed companies.⁷¹ Taking a company private protects it from this type of scrutiny, even though the decisions its executives make continue to affect the lives and livelihoods of workers, suppliers, customers and communities as before.

The complexity of the investment processes and structures used by private equity firms further shield their operations from public view, and the secrecy under which they customarily operate makes it difficult to find out whether they are violating labour, health, competition or environmental regulations. Much financial information about private equity funds and the companies they buy out can be obtained only from passive investors in the funds (such as pension funds and investment banks), which do regularly disclose financial information as part of the statutory reporting requirements of their home countries. Citizens remain in the dark about whether private equity's claims to create value and enhance efficiency have any basis in fact, unassisted by regulators, who tend to have little understanding of the private equity business model.

Private equity firms do need to disclose information when they go for a public listing on a stock exchange. For example, a lot of information about The Blackstone Group and companies under its investment portfolio came into the public domain when it filed for an IPO in early 2007 in New York. At that point, news media and the public learned that the majority of Blackstone's investors are public and corporate

Finding out what private equity firms are up to is nigh on impossible

70. "Bitter pill", *The Economist*, 17 March 2007, p.42.

71. See, for example, *Financial Market Lobbying: A New Political Space for Activists*, Corner House Briefing 25, January 2002, <http://www.thecornerhouse.org.uk/pdf/briefing/25finmkt.pdf>.

pension funds (with 39 and 15 per cent shares respectively). But IPOs are rare phenomena in the global private equity industry.

In response to growing public criticism of private equity's lack of transparency and disclosure, the British Private Equity and Venture Capital Association appointed the former chair of Morgan Stanley International, David Walker, to propose a code of conduct for UK-based private equity firms. The steering group assisting Walker was largely made up of private equity bosses. Released in July 2007, the Walker Report recommended that private equity firms should publish annual reports with information about the top partners, the performance of their funds and their fees.

This is a start, but the Report has several limitations. Private equity firms are not legally required to follow its recommendations, which are in themselves weak. The Report does not recommend disclosure of executive salaries nor of the profit shared by the fund's managers, nor the identities of the investors in private equity funds, nor information about how much of a fund's profits came from financial engineering rather than operational improvements. Its main requirement is simply a breakdown of investors. The Report does not recommend any change in the rules on disclosure. Indeed, the basic intention seems to have been to fend off any regulation that could bring transparency to the UK's private equity industry.⁷² Campaigners will need to continue to push for legislation under which private equity firms disclose important information at regular intervals to an appropriate regulatory authority in both home and host countries.

• Low Taxation

The private equity industry is also vulnerable to criticism of its tax privileges, particularly "carried interest". These tax breaks have provided the private equity industry's greatest competitive advantage over other businesses. Despite its public relations offensive, the industry has so far failed to convince policy makers and the public at large that multi-millionaire partners of private equity firms deserve them, particularly since they already earn so much revenue from management fees.⁷³

Although private equity firms have argued that increasing their tax rates would negatively affect returns, not even pension funds, which are among the firms' biggest investors, are opposed to the tax increases proposed in the US and UK. If the US government does impose a tax increase, as President Obama promised during his election campaign, and if the private equity industry carries out its threat to increase management fees in response, the big public pension funds may stop investing in them as a result.

In the UK, trade unions have taken the lead in raising awareness about the tax concessions enjoyed by the private equity industry. They have called for a minimum tax rate and closure of other loopholes in the tax system. In early 2008, the UK's Trade Union Congress proposed a "campaign for fair tax."⁷⁴

One reason why the US and the UK governments have supposedly been reluctant to tackle these tax and regulatory privileges is that they do not want to drive away rich residents or antagonise the financial community.

• Job Losses

Having been bought out by private equity, many companies have had to reduce their workforces, slash benefit packages and flout collective agreements with their workers. In August 2005, in one infamous case, Gate Gourmet, an airline catering firm then owned by Texas Pacific,

72. The self-regulatory code applies only to private equity firms authorised by the UK Financial Services Authority that own a large UK company, and to listed companies bought by private equity for more than £300 million and/or unlisted companies acquired for more than £500 million, which employ more than 1,000 staff in the UK and generate more than half their revenues in the UK. This means that only 32 of the British Private Equity and Venture Capital Association's 200 members are covered by the code and just 56 of the UK's 1,300 private equity-owned companies.

73. See Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," 9 September 2007 (<http://www.chicagosb.edu/research/workshops/finance/docs/metrick-pe.pdf>).

Pension funds have been influenced by unions on this issue. The proposed tax increase would not affect the overall returns of pension funds since they invest only a small portion of their money in private equity. For instance, the California Public Employees' Retirement System (CalPERS) – the world's largest pension fund with \$246 billions in assets – invests merely 6 per cent of its funds in private equity funds.

74. See Richard Murphy, *The Missing Billions: The UK Tax Gap*, TUC, London, February 2008, <http://www.tuc.org.uk/economy/tuc-14238-f0.cfm?theme=touchstone>.

assembled 670 staff in a car park at London's Heathrow Airport and announced over a megaphone that they were being sacked. British Airways staff at the airport walked out in support of the Gate Gourmet workers, while labour unions organised mass pickets of the catering firm.

Private equity proponents admit that buyout deals lead to significant job losses initially, but their counterclaim – that buyouts result in the creation of quality jobs in the long run – is not backed by statistical evidence. Labour unions and union federations, including Union National International (UNI) and Service Employees International Union (SEIU), have led the way in turning the spotlight on their job losses. To highlight the destructive impact of private equity buyouts, the SEIU organized a global day of action on 17 July 2008, including protests and demonstrations in cities around the world, to “Take Back the Economy”.⁷⁵

• Market Abuse

The secrecy surrounding private equity deals renders the potential for insider trading and market manipulation much higher than in transactions involving publicly listed companies. Investment banks, because they often act as both creditors and advisers to private equity funds and other clients, gain ample opportunities to trade price-sensitive information not available to others. Similar conflicts of interest occur in management buyouts when managers wish to buy a company with the help of private equity funds.

“Club deals” are another example of anti-competitive behaviour. By colluding, private equity firms can limit the number of competing buyers and thereby depress the price of a target company. In October 2006, the US Department of Justice launched an informal investigation into potentially anti-competitive behaviour by leading private equity firms, including KKR and Silver Lake Partners, when they acquired SunGard for \$11.4 billion.⁷⁶

Political Challenges Ahead

“When the music stops, in terms of liquidity, things will be complicated.”

Chuck Prince, (now former) CEO Citigroup, July 2007⁷⁷

“Be fearful when others are greedy and be greedy when others are fearful.”

*Warren Buffett
writing in the 2006 annual report of Berkshire Hathaway,
his holding company.*

In the US, the private equity industry is politically well organised. Sensing trouble over tax and transparency issues, firms have not only activated their own lobby groups, but have also formed alliances with other industries, such as real estate, energy and venture capital. According to media reports, lobbyists with strong connections to both the Republican and Democratic parties have been hired, and millions of dollars have gone to presidential and congressional campaigns.⁷⁸

In February 2007, US-based private equity firms joined hands to launch the Private Equity Council (PEC),⁷⁹ among them Bain Capital, The Blackstone Group, The Carlyle Group, KKR, Providence Equity Partners and Texas Pacific Group. Headquartered in Washington DC,

*US private
equity firms became
the employer of
choice for ex-senior
government officials
rather than
consulting or
lobbying firms*

75. See <http://www.july17action.org/>. See also “Behind the Buyouts: Inside the World of Private Equity”, a project of the Service Employees International Union: <http://www.behindthebuyouts.org/>

76. Dennis K. Berman and Henny Sender, “Private-Equity Firms Face Anticompetitive Probe”, *Wall Street Journal*, 10 October 2006.

77. Quoted in Michiyo Nakamoto and David Wighton, “Citigroup Chief Stays Bullish on Buyouts”, *Financial Times*, 10 July 2007.

78. In the US, private equity firms have added a new dimension to revolving door politics: they increasingly became the employer of choice for ex-senior government officials instead of consulting or lobbying firms. Paul O’Neill, former US Treasury Secretary, joined Blackstone as a special adviser in March 2003. Other former senior officials including James Baker (former Secretary of State), Frank Carlucci (former Secretary of Defense), and Dick Darman (former White House Budget Director) joined The Carlyle Group. Mitt Romney, who co-founded Bain Capital Partners, was a Republican candidate for the 2008 US presidential nomination.

79. <http://www.privateequitycouncil.org>.

80. Private Equity Council, *Driving Growth: How Private Equity Investments Strengthen American Companies*, <http://www.privateequitycouncil.org/wordpress/wp-content/uploads/driving-growth-final.pdf>.

the PEC aims to become a “leading advocate” for the domestic and international private equity industry. Although it is too early to gauge the success of this move, the PEC has already brought out a series of factsheets and documents to educate policy makers, media and public about the private equity industry’s contribution to the US economy, as well as a white paper entitled *Driving Growth: How Private Equity Investments Strengthen American Companies*.⁸⁰

China and Private Equity

In May 2007, the Chinese government announced its decision to buy a \$3 billion stake in the New York-based buyout firm The Blackstone Group – the world’s largest private equity firm – in an effort to diversify its overseas investments beyond US Treasury bills and bonds. The deal, which coincided with Blackstone’s \$4 billion initial public offering, gave China a 10 per cent stake in Blackstone.

The investment was carried out by the China Investment Corporation (CIC) which will hold its Blackstone shares for at least four years and was not allowed to invest in a competing private equity firm for one year.

CIC was formally launched in September 2007 and is essentially a sovereign wealth fund modelled along the lines of Singapore’s Temasek Holdings. It has been authorised to handle a sizeable portion (about \$200 billion) of China’s burgeoning \$1.3 trillion foreign exchange reserves. CIC will invest in global financial markets, oil, gas and commodities and reports directly to the State Council of the Chinese government.

The Chinese government’s stake in Blackstone took most observers by surprise. It is the first time that a government (particularly one calling itself communist) has invested public money into finance capital through such an investment vehicle. In the words of Stephen Schwarzman, Blackstone co-founder, “It’s a historic change. It’s a paradigm shift in global capital flows.”ⁱ

China’s stake in Blackstone enables China to bypass US political opposition to Chinese investments in the US, as witnessed during the bid by the state-owned Chinese oil com-

pany, CNOOC, to buy US-based Unocal in 2005. Despite an attractive buyout offer to shareholders, the US Congress opposed the sale of Unocal to CNOOC on “security” grounds. By investing in a private equity fund, however, the Chinese authorities can indirectly buy into corporations with far less attention or political opposition. Closer ties with Blackstone could also earn the country political dividends in containing the anti-China lobby in Washington DC.

The investment should also enable the Chinese authorities to get more dealmaking know-how.

From a Blackstone perspective, it is a prized deal. At a time when private equity firms (for instance, The Carlyle Group) are finding it difficult to do deals in China because of regulatory concerns and political pressures, this investment gives Blackstone an edge over rival players in China.

For the private equity industry as a whole, the deal indicates that there is another pool of capital they can tap in the wake of the global credit market crunch.

The China Investment Corporation has also invested \$3.2 billion in a private equity fund set up by New York-based J.C. Flowers & Co., which will invest exclusively in financial markets.

In addition, the Chinese government launched a private equity hybrid in June 2007 called the China Africa Development Fund with an initial investment of \$1 billion. With an expected lifespan of 50 years, the Fund is the largest ever private equity fund in China and the world’s largest single Africa-dedicated fund. The aim is to expand the Fund to \$5 billion with the participation of other investors.

Aimed at accelerating economic development in Africa, the China Africa Development Fund is fully

sponsored by the state-owned China Development Bank. Its mandate is to support Chinese companies’ trade and investment projects in Africa related to natural resources, infrastructure, housing, agriculture, manufacturing and industrial parks.

Its main businesses will be equity and fund investment, capital and investment management, and consultancy services. The Fund will not seek majority control or largest shareholding in businesses. It will combine the practices of both global private equity firms and China’s state-owned development banks. This Fund represents a partial restructuring of China’s state-owned banks to promote commercial operations.

At the same time, the Chinese authorities are encouraging the development of the domestic private equity industry to challenge the domination of foreign private equity firms in domestic markets and to ensure a level playing field.

Of late, they have tightened the regulatory environment that could restrict the buyout activities of foreign private equity funds. In 2006, the authorities introduced new regulations under “Provisions of Acquisition of Domestic Enterprises by Foreign Investors” to make sure that private equity and other foreign investors do not use acquisitions to circumvent foreign investment restrictions.

ⁱ Quoted in Andrew Ross Sorkin and David Barboza, “China to Buy a Stake in Blackstone,” *The New York Times*, 21 May 2007

Outside Washington, the biggest political obstacle to regulation comes from the European Commission, which is completely opposed to the regulation of the private equity industry. Justifying the Commission's stance, the EU's Internal Market Commissioner, Charlie McCreevy, blandly assured the *Financial Times* in February 2007 that:

"Hedge funds and private equity are good for the market. They have given greater liquidity, they have added shareholder value and they have helped the rationalization and innovation of companies."⁸¹

In 2005, the Commission established an Expert Group on Alternative Investment Funds and a sub-group on private equity funds. The Expert Group's July 2006 report proposed "light-touch regulation" for private equity funds, in line with the Commission's policy of further deregulating and liberalising the European Union's investment regime. The findings of the Expert Group ignore growing concerns about lack of transparency, tax evasion, use of leverage and market abuse expressed by Germany and official bodies such as the European Central Bank, the UK's Financial Service Authority and the International Organisation of Securities Commissions (IOSCO). They also present a sharp contrast to recommendations on the regulation of private equity made by the European Parliament to the Commission and to a critical report on private equity and hedge funds conducted by former Danish Prime Minister Poul Nyrup Rasmussen and the President of the Socialist Group in the European Parliament (PES). The PES report calls for legislative measures for greater disclosure and limits on the leverage used by the private equity industry.⁸²

The private equity industry has not been slow in retaking the offensive, however. The British Private Equity and Venture Capital Association (BVCA), along with other lobby groups, launched a major public relations exercise in June 2008 to woo the Members of the European Parliament (MEPs).⁸³ Nor have emerging markets been short of lobby groups representing private equity interests. The Washington-based Emerging Markets Private Equity Association (EMPEA) is one example.

These developments pose new challenges to both analysis and action. For a long time, pressure to liberalise investment in emerging markets has come from Northern countries and their investors, for example, during ongoing negotiations for bilateral and regional free trade agreements and for expansion of World Trade Organisation (WTO) agreements.⁸⁴ Now Southern-based private equity funds are joining in the chorus backing more liberalised inward and outward foreign investment regimes in their countries. This new domestic political constituency completely changes the power dynamic in the South, weakening the demand for more regulation and supervision of the private

Private equity poses new challenges to labour unions, NGOs and community groups

81. Quoted in Tobias Buck, "Hedge Funds and Private Equity 'Are Good for the Market,'" *Financial Times*, 20 February 2007.

82. *Hedge Funds and Private Equity: A Critical Analysis*, http://www.pes.org/downloads/Hedge_Funds.pdf

83. Mark Leftly, "Private Equity Begins Fightback Against Brussels", *The Independent*, 1 June 2008.

84. See, for example, Ellen Gould, *Financial Instability and the GATS negotiations*, CCPA Briefing Paper, Vol. 9, No. 4, July 2008, http://www.policyalternatives.ca/documents/National_Office_Pubs/2008/Financial_Instability_and_GATS.pdf.

Some Key PE Lobby Groups

Private Equity Council
(www.privateequitycouncil.org)

Institutional Limited Partners
Association (www.ilpa.org)

Emerging Markets Private Equity
Association (www.empea.net)

British Venture Capital
Association (www.bvca.co.uk)

European Venture Capital
Association (www.evca.com)

India Venture Capital Association
(www.indiavca.org)

Private Equity Industry Guidelines
Group (www.peigg.org)

National Venture Capital
Association (www.nvca.org)

China Venture Capital Association
(www.cvca.com.hk)

Southern-based private equity now backs more liberalised investment, changing the power dynamics in the South and weakening demands for more regulation and supervision of the private equity industry

Strategies to bring private equity under control need to be part of a wider political project for democratic renewal

equity industry both nationally and internationally.⁸⁵ It has yet to be effectively countered by sustained campaigning by citizens groups, NGOs and labour unions.

Nevertheless, there is growing public concern in many Southern countries over certain aspects of private equity. In South Korea, for instance, foreign investors have been attacked in local newspapers for pursuing an “eat and flee” strategy to maximise profits and minimise taxes. One example is the uproar over the 50.5 per cent ownership of the Korea Exchange Bank by Lone Star, a US private equity fund. South Korean prosecutors and regulators have been investigating the legality of Lone Star’s 2003 acquisition of the bank amid allegations that the fund manipulated the price of some of the bank’s shares before closing the deal.⁸⁶

The Future

Labour unions apart, civil society actors have so far had little input into policy debates on private equity at either national or international level. NGOs, citizens’ groups and corporate researchers have paid too little attention to the issue. Much of this neglect is no doubt due to the technicalities and complexities inherent in the business. But popular research and education could initiate a wider debate on private equity.

For workers, communities and the general public to have a say in buyout deals and other aspects of private equity operations is not only desirable but feasible. With the help of labour unions and other civil society actors, a concerted effort to educate and persuade the public, workers, policymakers and the media could bring about greater regulatory oversight, social control and public accountability of the private equity industry. If banks, pension funds and other financial institutions are regulated, why should private equity be an exception?

In the present context, no single set of regulations can effectively meet the public interest challenges posed by the private equity industry. What is needed is a coherent mix of national and international mechanisms. In the absence of international support, however, policy makers will have to rely initially on national mechanisms if they wish to regulate and supervise the private equity industry within their territories. National regulatory and supervisory responses should be regularly fine-tuned to check loopholes found and exploited by private equity players. Although there are several causes of the current crisis, the failure in the US to supervise and regulate the sub-prime mortgage market is close to the top of the list, while in the UK, “light-touch regulation” (for which read inadequate national supervision), and a lack of coordination between regulatory bodies were major contributory factors.⁸⁷ Greater coordination among national regulatory agencies could eventually pave the way for international mechanisms. Yet only if peoples’ movements are strong, alert and influential can the private equity industry be brought under social control and a strict regulatory framework adhered to even at the national level.

For either national or international strategies to bring private equity under control, they will have to be part of a wider political project for democratic renewal. A range of formal and informal campaigns mobilizing labour unions, NGOs, citizens groups, human rights groups and political groups could be formed at national, regional and international levels, energised by locally- or nationally-relevant concerns, for instance, job losses caused by the private equity industry or low tax rates paid by

85. The rise of Southern TNCs and sovereign wealth funds has also had a structural effect on global capital flows and thus on financial sector politics.

86. As of September 2008, Lone Star has been unable to sell its 51 per cent stake in the Korea Exchange Bank.

87. See Hildyard, N., *A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power*, The Corner House, October 2008, <http://www.thecornerhouse.org.uk/summary.shtml?x=562658>.

Resources on Private Equity

Several sources (print and on-line) provide information, analysis and databases on the global private equity industry. Most of these sources are commercial and therefore expensive. Quite often, there is a disparity in the data provided by different commercial sources.

Globally, **Thomson Financial** (www.thomson.com) and **Grant Thornton** (www.gti.org) monitor the developments in the private equity industry and provide macro data and analysis. Thomson VentureXpert offers the most extensive database on the private equity industry. Thomson also brings out a range of publications on the private equity industry including *Private Equity Week* (www.peweek.com), *Buyouts* (www.buyoutsnews.com), *Euro-
pean Venture Capital Journal* (www.evcj.com), and *Private Equity Hub* (www.pehub.com). Thomson Financial has also published directories on private equity firms.

Another commercial source of information is **Capital IQ** (www.capitaliq.com), a division of Standard and Poor's, which provides a comprehensive database of several private equity firms.

Apart from these sources, publishing and financial information firm **Dow Jones** brings out two monthly publications, *Private Equity Analyst* and *Private Equity Analyst Plus* (www.privateequity.dowjones.com), dealing with data, news and trend analysis of the private equity industry. Dow Jones also brings out a daily service on the buyout market called LBO Wire.

Dow Jones publishes the annual *Private Equity Funds-of-Funds, State of the Market*, which provides data and analysis on key trends in the funds of funds market, particularly fundraising, partnerships, investments and pricing.

The Deal (www.thedeal.com) is an on-line resource providing wide news coverage and analysis on M&As, private equity and venture capital. It brings out several daily, weekly and monthly newsletters and provides access to research, statistics and data on deal making.

Evalueserve

(www.evalueserve.com) provides a range of custom research and analytics on multiple industries including private equity. **Dealogic** (www.dealogic.com) is another industry source, which provides a comprehensive view of M&A activity worldwide including private equity transactions.

Private Equity Clearing house (www.privateequity.com) is a search directory of on-line information, website links and other sources serving private equity firms and institutional investors.

AltAsset (www.altassets.com) is an on-line news and information service. It is the only private equity site targeted specifically at institutional investors, although it is also visited by thousands of private equity firms and service providers. It contains the latest news coverage of the industry, in addition to opinions and analysis of the trends in private equity markets. AltAssets also provides an on-line library of information in the form of hundreds of articles and reports compiled and specially commissioned from expert sources.

Some private equity industry lobby organizations such as **European Private Equity and Venture Capital Association** also bring out newsletters, research papers, booklets and handbooks. Many of these publications are priced and available on-line.

The Hong Kong-based **Centre for Asia Private Equity Research Ltd.** (www.asiape.com) provides a range of information services on the Asian private equity industry. It brings out a monthly *Asia Private Equity Review* and also provides customised data services on the Asian private equity industry.

In India, **Venture Intelligence** (<http://ventureintelligence.in>), a private data firm, provides quarterly and annual reports on private equity investments and trends in India. **India Private Equity** (www.indiape.com) is another source of news reports and analysis.

For news reports on the global private equity industry, **Nexis** (www.nexis.com) provides an excellent collection of news stories published in English-language periodicals worldwide.

Another important source of

information is the events (such as conferences and training programmes) organized by the private equity industry and its business associates. By and large, invitations to such events are restricted to industry players and therefore not open to the public and media. Nevertheless, some are paid events: attendance (if you can afford the high charges) may offer valuable insights into the business and operations of the private equity industry.

Among critical voices, international confederations of labour unions are leading the way in demanding greater regulatory oversight and public accountability of private equity firms. Apart from lobbying policy makers, **Service Employees International Union** has published a report, *Behind the Buyouts: Inside the World of Private Equity* in April 2007, available at its website exclusively devoted to buyouts deals (www.behindthebuyouts.org).

In May 2007, the **International Union of Food Workers** published *A Workers' Guide to Private Equity*. Its website, **IUF's Private Equity Buyout Watch** (www.iuf.org/buyoutwatch), contains news and analysis on the private equity industry, particularly the impact and implications of buyout deals on the workers.

In June 2007, the **International Trade Union Confederation** published a report *Where the House Always Wins: Private Equity, Hedge Funds and the New Casino Capitalism* (www.ituc-csi.org/IMG/pdf/ITUC_casino.EN.pdf), which gives a macro overview of the private equity industry and the issues involved.

The **Party of European Socialists** has been very active in demanding greater regulation of private equity and hedge funds. It has brought out a publication titled, *Hedge Funds and Private Equity – A Critical Analysis* (http://www.pes.org/downloads/Hedge_Funds.pdf).

Critical commentaries and analysis on several big private equity firms such as The Blackstone Group and The Carlyle Group are available on blogs.

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private equity investors. In the case of India, where infrastructure dominates private equity investments, key questions go beyond merely asking whether India needs infrastructure or not. More pertinent ones are: Infrastructure for whom? Who pays? Who benefits?

The sub-prime mortgage crisis in the US exposed the structural linkages between private equity, securitisation vehicles, investment banks and credit rating agencies. The demand for effective regulation of private equity cannot be disentangled from the need for better regulation of other major financial actors. A unified approach toward regulation of all major players will be an important topic for the coming debate.

Corner House Briefing 38 **Sovereign Wealth Funds: Some Frequently Asked Questions**

www.thecornerhouse.org.uk/pdf/briefing/SWFFAQs.pdf

Western politicians, business leaders and commentators seem paranoid about state-owned sovereign wealth funds (SWFs), particularly those from the Middle East and China. They fear that SWFs follow strategic political objectives — investing in Western companies and banks to secure control of strategically important industries such as telecommunications, energy and banking — rather than commercial interests.

A protectionist backlash against sovereign wealth funds is fast emerging: the USA, Canada, Australia and Germany have introduced substantial legislative changes to screen and restrict investments by SWFs and other state-owned entities. European Parliaments are considering regulations to curb the potential impact of SWFs on

financial markets, corporate governance and security.

Are such fears based on facts or assumptions? Is the “invasion of sovereign wealth funds” real? Do SWFs pose a direct threat to financial stability? Do they have hidden agendas? Are SWFs driven by political considerations? Are governments really using SWFs to pursue nefarious foreign policy objectives? Should anyone be afraid of sovereign wealth funds? Are SWFs providing long-term investments and stability to ailing businesses and economies?

This paper examines these questions in order to understand the potential impact and implications of sovereign wealth funds in a rapidly-changing global political economy.

Corner House Briefing 39 **A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power**

www.thecornerhouse.org.uk/pdf/briefing/WallMoney.pdf

As world stock markets plunge and even the most neoliberal governments nationalise banks and mortgages lenders, there is a widespread view that North America and Europe — so willing in the past to dictate to developing countries on how to run their economies — are on the brink of a major slump. Millions are threatened by job losses or repossession of their homes. Uncertainty abounds.

But the crisis also offers an opportunity for the public to redefine what constitutes the “public interest” and to reassert its claims and interests over how finance should be managed in future and in whose interest. Understanding how the current “financial 9/11” came about — beyond simply blaming “greed and fear” — may cast light on the structural changes that are needed if history is not to repeat itself.

A starting point for analysis is the largely unregulated “shadow banking system” that financial entrepreneurs created over the past 30 years to make huge profits for themselves, circumvent regulation and offload risk onto others. The system relied on the creative use of new financial instruments, particularly derivatives, that allowed financiers to generate easy credit by taking high risk bets while dumping the risks elsewhere.

In so doing, they created “a wall of money” that fuelled a boom in corporate mergers and acquisitions across the USA and Europe, concentrating economic power in the process. Easy credit provided huge sums of capital for companies involved in mining, biofuels, private health care, water supply, infrastructure and forestry to expand their activities. When the bets went wrong, however, the pyramid of deals began tumbling down — and it is the public that will carry the costs for many years to come. This paper explores and summarises:

- how the shadow banking system was constructed and why;
- the history of the derivatives, “hedgies” and speculation that underpinned this new finance;
- how derivatives are being used to get around banking, accounting, trading and public finance rules;
- the negative impacts on the ground even before the current crisis;
- recommendations put forward on how to fix a broken system; and
- how best to pursue a different system that has a genuine public interest at its centre.