Taking it Private
Consequences of the Global Growth of Private Equity

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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 gone 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. And 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 a higher price and 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

[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: there were high profile court cases involving the unscrupulous business practices of several IT companies; chaos predicted from 1 January 2000 onwards because of a programming "millennium bug" did not occur; and unemployment rose among computer programmers because of increased outsourcing. To deal with the ensuing recession, the US Federal Reserve cut interest rates – and in so doing encouraged the cheap mortgage and other credit lending that has contributed to the current crisis.

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]

But 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 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 their 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 is reshaping the way business is being conducted. Private equity firms do not take long-term stakes in the companies in which they invest and 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 move 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 are increasingly overshadowing 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

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[3] "The New Kings of Capitalism," *The Economist*, 25 November 2004.

[4] "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, as Chair of the Social Democratic Party (SPD) in Germany, made this comment in April 2005 during the national election campaign (quoted in "*Hedge and Private Equity Funds*," PES, 2007). He subsequently published a "locust list" of companies that he circulated within the SPD.

[5] Service Employees International Union, *Behind the Buyouts: Inside the World of Private Equity*, April 2007, p.10.

[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 Dore, R., *Stock Market Capitalism: Welfare Capitalism: Japan and Germany vs. the Anglo-Saxons*, Oxford University Press, Oxford, 2000.

challenges are especially clear in Asia, which became more attractive for private equity firms when 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 investment[7] in assets or companies that are not listed on public stock exchanges. Shares are bought, sold and issued privately. Private equity firms invest in companies at various stages of their development ranging from their very beginnings to their demise. "Angel investors", usually individuals, finance companies during their start-up phases, while venture capital is put into firms during take-off, but most private equity investment is concentrated on companies during the later stages of their growth and when they are in distress.[8] Here private equity firms have depended 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 is a management firm that has unlimited liability, 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.

A private equity fund raises money from a variety of outside investors including investment banks, financial institutions, pension funds, university endowment funds and wealthy individuals. Since private equity funds are generally less regulated by national legal authorities than other funds (such as mutual funds and pension funds[9]) and are therefore considered very risky, only big institutional investors and wealthy individuals are approached to contribute to them. In the US, for instance, most private equity funds

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[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.

[9] 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 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.

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 of pension funds, university endowments (for instance, Harvard University's $34 billion endowment[10]) and sovereign wealth funds in private equity businesses means that in fact a significant amount of money flowing into private equity funds globally is "public" in nature, not private. Yet these outside investors do not participate in the funds' investment decisions. All these investors have 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.

With average life spans of 8-10 years, private equity 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 money with a fund, the money remains locked up for the duration of the fund's life. Unlike investors in publicly listed companies, who can sell their shares at any moment (assuming someone 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 also 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.

The Players

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, these companies 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 (*see* Table 1, p.5). 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 (*see* Annex 2, pp.52ff. for more information).

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

[10] 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.

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, Coles and Debenhams.

Table 1
Top 20 Private Equity Firms (as of April 2007)

Private Equity Firm	Assets Under Management ($ billion)	Portfolio Company Employees
The Blackstone Group	79	350,000
The Carlyle Group	56	200,000
Bain Capital	40	662,000
Texas Pacific Group (TPG)	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 Dublier & 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.
http://www.behindthebuyouts.org

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 PE firm, Alchemy Partners.[11]

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 have made extensive use of "leveraged" or borrowed finance to buy out companies – they borrow money to acquire a company's shares in hopes 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 offload 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 subprime mortgage crisis that has engulfed the US since mid-2007 has revealed (*see* Box 1, pp.8-11).

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 offshore 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 information creates considerable potential for market abuse. Private equity's importance is magnified further by its links with two other increasingly prominent financial vehicles. The first is sovereign wealth funds (SWFs) – state-owned funds comprising financial assets such as stocks, bonds, property or other financial instruments. The second is hedge funds, another type of private unregulated pools of capital (*see* Box 2, p.11).

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. It is the largest private equity investor in India. Similarly, in May 2007, the China Investment Corporation, another SWF, announced its decision to buy a $3 billion stake in the private equity giant The Blackstone Group. In September 2007, Mubadala, the sovereign wealth fund of Abu Dhabi's Government, bought a 7.5 per cent stake in The Carlyle Group for $1.35 billion.

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[11] 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.

Hedge funds are also getting into the act. For instance, Old Lane, a US-based hedge fund, has created a private equity fund that invests in India and other Asian markets. One reason this is important is that a lot of official reserves, which provide the liquidity for most financial markets,[12] are now in hedge funds, taking up, by one estimate, some 25 to 50 per cent of hedge fund activity.[13] When the big US-based hedge fund LTCM (Long Term Capital Management) collapsed in 1998, for example, it came to light that the Italian central bank had invested $250 million in it.[14] In effect, private equity firms, SWFs and hedge funds are managing liquidity in the global markets to the tune of some $10 trillion.

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[12] 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".
See "Defining liquidity", *Financial Times*, 10 August 2007, http://www.ft.com/cms/s/1/5b2e71cc-471d-11dc-9096-000779fd2ac.html.
See also "When the rivers run dry: Can bank regulators and central banks prevent future liquidity crises?" *The Economist*, 8 March 2008.

[13] 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. A central bank is a national government bank rather than a commercial, private, investment or retail bank. Its two main tasks, according to *The Economist*, 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. 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.

[14] Long-Term Capital Management (LTCM) was a US hedge fund considered to be "the Rolls Royce of hedge funds". It was set up in 1994 and had returns of over 40 per cent in its initial years. By 1998, it had built up an exposure of some US$900 billion mostly in Northern capital markets. During one month in 1998, however, it suffered a 44 per cent fall in its net asset value when the financial markets unravelled after Russia defaulted on its debt. Its near collapse triggered financial problems in the well-known and established financial institutions that had lent to LCTM. The knock-on effect of a collapsing pyramid of deals considerably 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 stepped in to bail out LCTM. The fund folded in early 2000.
See Lowenstein, R., *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Fourth Estate, London, 2002.

Box 1
The SubPrime Mortgage Crisis, the Credit Crunch and Private Equity

Financial crises seem to be occurring with increasing regularity, but the unfolding global credit crisis that began in 2007 is more serious than many of its precedents. It originated in the US subprime housing mortgage market, but soon spread to other developed economies including Germany, the UK and Japan.

The subprime crisis is an outcome of booming housing markets in a deregulated financial environment. From 2003 onwards, housing markets in the US expanded rapidly because interest rates were low. Mortgages to buy homes were pushed on so called "subprime" borrowers – those who do not qualify for market-rate (or prime rate) loans because of their low income or poor credit history.

Unscrupulous lenders started relaxing the lending conditions for their 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 subprime business now accounts for 20 per cent of all housing loans in the US.

These loans were not provided out of altruistic motives, but to earn increased profits: the lenders charged the subprime 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, unsurprisingly, borrowers started defaulting on their housing mortgages as variable interest rates increased. 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. Subprime borrowers could not meet their mortgage payment obligations and defaults began to increase.

Until a few years ago, the financial industry's own 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 a phenomenon called "securitisation".

In the securitisation process, lenders bundle together a number of mortgage loans and sell them to a Special Purpose Vehicle (SPV), which they generally set up offshore (*see* footnote 21). The SPV slices up the bundle (known as a Residential Mortgage Backed Security or RMBS) into "tranches". Rating institutions, such as Moody's and Standard & Poor, rate these tranches 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).

The SPV then sells “derivatives”, known as Collateralized Debt Obligations (CDOs), on the different tranches. Those who buy the derivatives obtain an income stream based on (or “derived” from) the mortgage repayments, but the underlying mortgage loans remain the property of the SPV. A high risk tranche pays out more income than a low risk one. Derivative buyers have included investment banks, hedge funds, insurance companies and pension funds across the world. Typically pension funds invest in senior tranches while hedge funds invest in equity tranches. Some investors have gone on to borrow money using their derivatives as collateral; the income from the derivative has generally been higher than interest on the borrowed money.

The securitisation process enabled mortgage lenders to offload onto others the loans to the sub prime borrowers (but not the risk, as the current financial crisis shows) within days of the mortgages being taken out. With the loans removed so rapidly from their balance sheets, mortgage lenders had little incentive to verify the credit history of their subprime borrowers. 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. The loans having disappeared from their own balance sheets, the original lending institutions felt that default was now someone else’s problem – the problem of whoever had bought the mortgage or a share in it.

Many investors bought these CDOs because they had received the top AAA ratings from the ratings agencies 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 on their mortgage payments, rating agencies downgraded their rating of CDOs. Suddenly, investors found that they were holding devalued securities that could not be traded at all.

A sharp fall in house prices is now pushing rates of mortgage defaults even higher. Over two million American homes are expected to be taken away from those who can no longer pay the mortgages. The crisis has already ruined many lives. The worst sufferers have been those in lower income groups, particularly 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 up worldwide, the subprime mortgage crisis has spread outside the US. Banks that were late in understanding their large exposure to subprime mortgage markets have suffered huge losses. Some of the worst sufferers have been Bear Stearns (US), IKB Deutsche Industriebank (Germany), BNP Paribas (France) and Lehman Brothers (US and UK), which has now gone into receivership.

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. Since August 2007, liquidity has dried up in all major markets. In the US, Europe and Japan, central banks had to intervene to inject liquidity into the global financial system because US and European investment banks no longer wanted to lend money to each other in view 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, 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 eventually nationalised the bank in February 2008.

In March 2008, the US Federal Reserve re-wrote its rule book to rescue Bear Stearns, the fifth largest investment bank in the US, 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 as it filed for bankruptcy, the largest ever in the US.

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 the Swiss banking system's reputation for reliability, this bank's latest nickname is Used to Be Smart.

Because these securities are now illiquid and thus not easily valued, no one really knows where the subprime crisis will end, or its ultimate magnitude. Nevertheless, the disaster raises three important policy lessons. First, in a deregulated financial system, it is all too easy for banks and financial institutions to 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 offloaded it and concealed it among other market players through the use of sophisticated techniques.

Third, unregulated rating agencies have become a hazard to 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 increases the international financial system's dependence on rating agencies even further – is finally adopted by all US banks.

Box 2
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 buy and sell at breathtaking speeds stocks, shares or derivatives without gaining management control. Hedge funds typically invest in liquid assets in financial markets, such as stocks and shares, bonds, currencies and commodities.

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 do suggest that these distinctions are blurring. Increasingly, hedge funds are sources of the vast amounts of capital 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 more associated with banks, thereby hoping to harvest higher returns and diversify their risks.

This coming together of private equity and hedge funds may lead to greater competition and higher prices for acquisitions, which, in turn, would negatively affect financial returns in the long run.

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, as noted above, 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 cost of raising money via the stock exchange. Surprisingly, the ICFC had no funding from government. For many years, the bulk of financing provided to companies by ICFC (renamed Investors In Industry – or 3i – in 1983) was in the form of preference shares[15] 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 restrictions on undertaking buyouts were relaxed and the Unlisted Securities Market was created in 1982, which allowed the listing of start-up companies and thus enabled small or new companies to raise funds for their business development.[16]

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.[17] The industry then benefited greatly from special tax and legislative measures, such as lower taxes on capital gains and relaxed disclosure and investment regulations, that were introduced in the 1980s. Private equity firms shot to prominence in the US when KKR launched a hostile bid[18] 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")*.*[19] Indeed, most of the deals in the 1980s and early 1990s were hostile takeovers.

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[15] 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.

[16] 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 a US stock exchange after the Sarbanes-Oxley Act was introduced in the United States in 2002 (*see* footnote 28).

[17]http://en.wikipedia.org/wiki/American_Research_and_Development_Corporation.

[18] A hostile bid is an attempt to buy or takeover a company without informing the company's board beforehand or when the board has rejected the offer.

[19] Burrough, B. and Helyar, J., *Barbarians at the Gate: The Fall of RJR Nabisco*, ArrowBooks, London 2004.

Nonetheless, by and large, the private equity industry remained relatively modest in the early 1990s, totalling $10 billion in 1991. In the mid-1990s, however, the business gathered pace. 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 buy-outs ever done."[20]

Looking for Opportunities

Private equity firms are set up differently 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.[21]

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.[22] 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 the General Partner of a private equity fund. In addition, the General Partner is entitled to "carried interest," a performance fee paid to managers based on the profits generated by the fund. Typically, the General Partner gets carried interest of 20 per cent of the profits. Often, gross private equity returns are in excess of 20 per cent per year, particularly in the case of leveraged buyout firms. 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 therefore 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 –

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[20] "Loan rangers: Private equity and banks", *The Economist*, 30 August 2008, pp.81-82.

[21] A special purpose vehicle (SPV) is a legal entity or corporate body, such as a limited company or partnership, created for the sole purpose of acquiring and holding certain assets for the sole benefit of investors in the SPV. A bank or company may transfer assets to a SPV for several reasons, such as to isolate and thereby protect assets in the event of bankruptcy, to avoid taxation or regulation, or to remove loans from a balance sheet. The SPV can issue derivatives based on the income streams from these assets (*see* Box 1, pp.8-11). The SPV investors may include the entity that sold the assets to the SPV in the first place, such as a bank selling its mortgage loans.

[22] 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.

not least on the grounds that there are other sections of society that need tax exemptions 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."[23]

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 can expect to collect $10.35 in management fees for every $100 they manage. Slightly more than half of this amount – $5.41 for every $100 – comes from "carried interest".[24] With buy-outs running into tens of billions of dollars, key partners extract management fees of hundreds of millions of dollars annually to take home on top of 20 per cent or more of the profits. No wonder the key 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.[25] This compensation is 22,255 times greater than the pay of an average US worker.[26]

The Buyout Business

Private equity firms finance their operations not only through equity but also through debt. They provide the equity, and get loans from banks (although the debt is often transferred subsequently to other financial institutions through securitization, *see* Box 1, pp.8-11)). In a typical leveraged buyout deal (*see* Box 3), 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.

Box 3
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 own balance sheet and its own cash flow is used to repay it. This is why private equity firms generally target companies with a steady cash flow.

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[23] Quoted in "SVG Chairman Breaks Tax Taboo," *Financial Times*, 3 June 2007.

[24] Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," 9 September 2007, http://www.chicagogsb.edu/research/workshops/finance/docs/metrick-pe.pdf.

[25] "Big Paycheck", *Forbes*, 3 May 2007.

[26] Sarah Anderson, John Cavanagh and others, "*Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership*," The Institute for Policy Studies and United For a Fair Economy, 29 August 2007.

Leveraged buyouts enable private equity firms to undertake mega-acquisitions without themselves having to commit as much capital as they would otherwise have to. A typical LBO comprises 80 per cent debt and 20 per cent equity.

Private equity firms pioneered the leveraged buyout industry. KKR is believed to be the first to have used the strategy when it acquired a majority stake in the Orkin Exterminating Company in 1964. Private equity firms benefit greatly since 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.

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.

Private equity firms practise two distinct types of buyouts:

- Leveraged Buyouts (LBO), in which private equity firms use debt to take control of a business;

- Management Buyouts (MBO), in which private equity firms help the existing management of a company to acquire it and gain a stake in the company in return.

The buyout process starts by taking a publicly listed company completely private – that is, the private equity firm buys up enough of the shares of a company listed on a stock exchange to have the power 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, enabling a 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.)

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 limited partners of private equity funds. Taking firms private also allows private equity firms to bypass the responsibility of complying with certain regulations

(such as the 2002 Sarbanes-Oxley Act in the US[27]). Indeed, lack of transparency is essential to the private equity business model.

Private equity funds provide not only capital but also business expertise to the firms they invest in, and usually assume complete management control. Joining the boards of the portfolio companies, they have 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. However, private equity firms usually 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 companies that generate high cash flows than in those with high growth prospects. Companies with high cash flows have an easier time servicing the additional debt that their private equity investors take on during buy-outs.

Private equity firms try to increase the value of the companies they buy or invest in by restructuring them, such as by reducing staff, closing plants, administrative overhauls, selling non-core operations and changing internal processes, generally over a three to five year time span. Then 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 selling to another private equity or strategic investor, or recapitalizing. In recapitalization, the private equity firm pays itself a special dividend – usually funded by the portfolio or the acquired company's borrowings. In 2005, there were an estimated $28.1 billion of recapitalization transactions. The bulk of these transactions were used to pay special dividends to financial sponsors, leaving the portfolio companies loaded with even more debt.

In a nutshell, then, private equity firms tend to buy companies not to own and run them with a long-term perspective (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.

Improving Operational Efficiency or Quick Flipping?

Private equity funds' buyout deals are designed primarily to make quick profits through management fees and financial engineering[28] rather than improving the viability of the

[27]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.

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.[29] Since 2000, some private equity outfits have extracted dividends to the tune of a 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 $1.43 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 the company 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.

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, another equity firm, 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.

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 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 of debt. According to Thomson Financial data, 55 per cent of the proceeds from buyout-

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[28] Financial engineering creates new financial products or instruments by repackaging existing ones; it often refers to the use of securitisation, derivatives, hedging and other derivative pricing techniques.

[29] 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/f8b280d736e74db3c125727a00524bd3?OpenDocument

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.[30]

Unsurprisingly, Moody's Investors Service, the credit rating agency,[31] 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."[32] A 2007 Moody report states:

> "We also question whether there is sufficient evidence to prove that the higher returns provided to private equity are driven by stronger management teams or because, in a benign and liquid credit environment, leverage by itself can provide substantial returns to shareholders."[33]

Recent Trends

The period from 2000 to mid-2007 saw low interest rates, a worldwide glut of capital, buoyant credit markets, rising corporate profits and a massive growth in structured credit products such as collateralised debt obligations (*see* Box 1, pp.8-11).

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 companies. 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

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

[31] 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 to service that debt and repay the principal and interest at specified dates. 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 (which is legally obliged to obtain a rating), not the buyer or investor. In US law, their ratings are deemed "opinions" and thus protected in law as free speech. Before the subprime mortgage market collapsed in 2007, exposing the problems with securitization, almost half the revenue of leading rating agency Moody's came from structured finance. ("Fear and loathing, and a hint of hope: Securitisation", *The Economist*, 16 February 2008, pp.81-83).

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

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

Morgan Chase picked up $12.8 billion in fees from private equity firms, and in the first half of 2007 alone, another $8.4 billion. 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 due to the associated potential for market abuse.[34]

Since 2005, private equity firms increasingly relied 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 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.

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. These deals 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 are increasingly concerned that private equity funds may be conspiring or colluding to manipulate the purchase price of the target company.

Box 4
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.

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[34] 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.

• Over the past 10 years, private equity has outperformed stock market indices such as the Standard & Poor (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.

• Of late, development finance institutions such as the World Bank's International Finance Corporation (IFC), the Asian Development Bank and Germany's Investment and Development Company are also committing money to private equity funds.

Table 2
Private Equity Buyout Deals

Target company	**Value**	**Buyer(s)** ($ billion)	**Year**
TXU	43.8	KKR, TPG, Goldman Sachs	2007
Equity Office Properties	38.9	Blackstone	2007
Hospital Corporation of America (HCA)	32.7	Bain, KKR, Merrill Lynch	2006
RJR Nabisco	31.30	KKR	1989
Alltel	27.9	TPG, Goldman Sachs	2007
First Data	27.7	KKR	2007
Harrah's Entertainment	27.4	TPG, Apollo	2006
Hilton Hotels	25.8	Blackstone	2007
Alliance Boots	20.6	KKR	2007
Freescale Semiconductor	17.6	Blackstone, Permira, Carlyle, TPG	2006

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Albertson's	17.40	Cerberus	2006
Intelsat	16.4	BC Partners, Silver Lake Partners	2008
Hertz	15.00	Carlyle, Clayton Dublier & Rice, Merrill Lynch	2005

Compiled from company reports, Dealogic, *The Economist* estimates, news reports and industry documents.

The Buyout Cycle Turns

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 subprime mortgage lending in the US gradually began to collapse, triggering bank losses worldwide and eventual collapses (*see* Box 1, pp.8-11), credit spreads – premiums that riskier borrowers pay over sovereign debt – 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.[35] 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 Buy-Out model has lost its attractiveness. The markets for Collaterised Debt Obligations (CDOs) and Collaterised Loan Obligations (CLOs) – 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) have reported huge losses since mid-2007, when they discovered their exposure to the leveraged loan and subprime mortgage markets. By mid-2008, these four banks alone had announced asset write-downs of almost $50 billion. 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 had 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

[35] By contrast, strategic corporate buyers 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 strategic buyers which can now acquire firms at lower costs.

playing, you've got to get up and dance. We're still dancing."[36] Just three months later, however, the music had stopped and the party was over.[37] In September 2008, Merrill Lynch was bought by Bank of America and, more importantly, Lehman Brothers, one of the main US investment banks, went bankrupt.

The biggest losses were at Citi, which has written down $56.6 billion since the beginning of 2007. Merrill Lynch came next with $51.8 billion, followed by Morgan Stanley ($14.4 billion); J.P. Morgan ($12.8 billion); Goldman Sachs ($3.8 billion) and Bear Sterns ($3.2 billion). *See*: Gapper, J., "Big Freeze part 2: Banking", *Financial Times*, 4 August 2008, http://www.ft.com/cms/s/0/cc160f46-624f-11dd-9ff9-000077b07658.html.

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 $19 billion in August 2007.[38] Some big private equity firms cannot now pull-off mega-buyout deals because of prevailing credit market conditions and a lack of investor appetite. For instance, KKR 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 are in limbo. Financing packages for the acquisitions of Alliance Boots, Chrysler, First Data and Cadbury Schweppes were all postponed in July 2007. Most of these acquisitions did go ahead a few months later, but the private equity firms had to offer higher yield on the 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 leverage or debt has pushed some portfolio companies into bankruptcy or liquidation. For instance, 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.

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[36] Quoted in Michiyo Nakamoto and David Wighton, "Citigroup Chief Stays Bullish on Buyouts," *Financial Times*, 10 July 2007.

[37] 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.

[38] Jason Kelly, "Buyout Firms Could Find it Harder to Make Big Returns," *International Herald Tribune*, 29 August 2007.

The bursting of the credit bubble will also affect investors in private equity funds who now face meagre returns on their investments. Already the process of deleverage (paying off debts by selling assets quickly) has picked up as some investors try to pull out of investments 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.

Even equity markets have 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" cannot 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 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" have 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. But with a worldwide glut of capital over the past few years, investors had been able to keep moving from one asset class to another. In the process, they have changed business dynamics significantly. The boom-bust cycle has become an integral part of the present-day global financial system – except this bust seems somewhat louder than more recent downturns.

Private Equity Shifting Strategies

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 hedge funds and banks, increases the chances of a comeback.

Yet private equity funds are likely to have to change their business strategies and models (and staff to obtain 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 growth deals achieved through acquiring a minority stake. The private equity funds of the future are likely to be more specialised and sector-focused. Banks will not and cannot fund mega buy-outs, but may still be willing to make loans for smaller deals below the $500 million level.

With an expected dramatic 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). Funds may also buy the debt (at discounted prices) in their own buy-out 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.[39] No one seems to know if it's legal or not for a company to own its own debt.[40] And some private equity funds may enter public markets (stock exchanges) to put their un-invested capital to work and to earn management fees.

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 as secondary lenders before, 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 multibillion-dollar funds from such investors. But while investment banks may provide less leveraged debt finance, they are likely to continue to provide advisory services.

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),[41] and perhaps 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

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[39] *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 the 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."
("All Clear?", *The Economist*, 17 May 2008, p.80-82.)

[40] 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.

[41] 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). Mezzanine finance itself has one or more characteristics of both debt and equity: if a company goes bankrupt, it ranks after normal debt but before equity; it pays higher interest rates than other debt; it can be converted into shares; and it is repayable only after some seven to ten years.
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.

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."[42] Some big private equity firms such as KKR, The Carlyle Group and The Blackstone Group have already initiated steps in this direction. 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 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.[43]

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. Emerging economies, particularly India and China, are, as yet, largely unaffected by the credit crunch and enjoy high economic growth rates, stock market liquidity, political stability, strong corporate performance and a burgeoning middle class. The United Arab Emirates (a leading financial hub in the Middle East) and Saudi Arabia (which hosts the Middle East's largest stock exchange) are also attractive to private equity investors.

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 Shariah 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 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 (*see* Box 5, pp.27-28), is a good case study.

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.

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[42] Paul Fletcher, quoted in Martin Arnold, "Reward is worth risk for growth market gurus", *Financial Times*, 21 August 2008, http://www.ft.com/privateequity.

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

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 traditional 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 (although a sovereign wealth fund), 3i and Citigroup (*see* Annex 1, pp.47ff). 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.

India's home-grown private equity firms are meanwhile 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 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 particularly on providing venture capital for start-ups in the information technology sector, which the government was promoting. But from mid-2000 onwards, that has changed fast for several reasons.

First, the Indian authorities opened up industry to more foreign investment. For instance, foreign investment limits in the telecoms sector have been raised from 49 per cent to 74 per cent. In the retail sector, 51 per cent foreign direct investment is now allowed in single brand products. 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 township development. 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 thus easy prey for private equity firms. 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 excellent 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 and networks. Some Indian corporate houses such as the Ajay Piramal Group and Dalmia Group are also entering directly into the private equity business 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, there has been no screening of such investments by Indian authorities.

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 that 10 per cent of the company's capital, they should be treated as portfolio investments.

Due to their political and economic clout, private equity funds have remained 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 in India. 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.

Box 5
Private equity trends and developments 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.

(continued on next page)

• 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.

Table 3
Private Equity Investment in India ($ billion)

2004	2005	2006	2007
1.1	2.2	7.4	17

Growth Deals Dominate Instead of Buy-Outs

Global private equity funds has adopted different strategies in India than in Europe and the US. While in Europe and the US, private equity has tended to be 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, in India, most domestic businesses 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 buy-outs. 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. According to data firm Venture Intelligence, private equity and venture capital funds exited from 160 companies through either 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 (*see* Table 4)

Table 4
Key Private Equity Buyout Deals in India

Date	Target Company	Buyer	Deal value ($ million)
August 2007	Gokuldas Exports	Blackstone Group (USA)	165
June 2007	Intelenet Global Services	Blackstone Group (USA)	200

September 2007	Nilgiris Supermarket	Actis (UK)	65
June 2006	Nutrine Confectionery Co.	IL&FS Investment Managers (India)	80
April 2006	Flextronics Software Systems	KKR (US)	900
July 2005	ACE Refractory	ICICI Venture (India)	59

Compiled from news reports and industry documents.

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, paid $60 million for 29 per cent of equity in state-owned Punjab Tractors Limited (PTL) in 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. Within three years, in other words, Actis (which was spun off as a management buyout from the UK government's Commonwealth Development Corporation [CDC] in 2004, with CDC remaining its largest investor) 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, which typically have a difficult time accessing traditional forms of equity financing, and are popular when the stock markets are in panic.

Bullish on Infrastructure

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. In India, infrastructure investments are 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.

Many private equity players such as IDFC Private Equity have already earned mega-profits from such investments. 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).[44] 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. 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 capital on its Western coast, and modernization projects at the airports in these two cities. Most roads and bridges are being implemented on a build, operate, transfer (BOT) or build, operate, own and transfer (BOOT) basis. Where Private-Public Partnership (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 demand-supply gap. India reportedly needs to generate an additional 70,000 MW to meet its growing energy requirements, and the 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, has delivered annual returns of 55 per cent since its launch 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. By bypassing capital controls on foreign investments, it also allows the private equity funds to exit easily by selling their equity to other investors. Since holding companies can issue IPOs in stock markets more easily than a specific infrastructure company, the approach also frees up finance for future infrastructure investments.

[44] The Indian government plans to set up 12 UMPPs in India. The UMPPs are large projects, approximately 4,000 MW each, that would supply power to a number of power distribution entities located in different States and 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 impact on climate change and global warming.

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 India. The Initiative will be managed by the Infrastructure Development Finance Corporation of India (IDFC), a state-owned specialized financial intermediary that finances almost a quarter of the country's private 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 equity component of the Initiative. 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 in India, especially power plants, ports, logistics, airports and road projects. The 3i Group has launched a 3i India Infrastructure Fund with a target of $1billion in 2007, the first billion-dollar infrastructure fund launched by a foreign private equity investor. This fund will focus on early-stage and mature operations within power generation, ports, airports and road projects. Of this amount, the private equity firm alone 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. Already the 3i Group has 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. 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.

Box 6
Delhi-Noida Flyway:
A Flawed Public Private Partnership (PPP) Model

Despite their popularity within government and business circles, private-public partnerships have remained highly controversial in India because some projects offer almost guaranteed returns, a low risk of political clearance and assured usage of services. The Delhi-Noida bridge project, which is often touted as a

"pioneer" for Public Private Partnerships (PPPs) in India, is a case in point. Apart from being India's first big PPP, it 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.

The project was promoted by Infrastructure Leasing and Financial Services Limited (IL&FS), whose shareholders over the years have included leading domestic and international institutions such as Central Bank of India, Housing Development Finance Corporation (HDFC linked with The Carlyle Group), ORIX Corporation (Japan), Credit Commercial de France, Abu Dhabi Investment Authority and the World Bank's International Finance Corporation (IFC).

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

The Company is listed on Indian stock exchanges while its global depository receipts (GDRs) 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 the public authorities shoulder all the risks. A recent study carried out by a consultant with India's Planning Commission noted that:

"The concession agreement for the Delhi-Noida bridge project has several features that appear to weigh the contract in favour of the private partner and that, from a public policy viewpoint, depart from best-practice contract design."[45]

The study points out several objectionable clauses favouring the private partner:

- The concessionaire gets guaranteed returns of 20 per cent per annum of the total cost of the project, not of its equity. If there is shortfall in returns because of a fall in toll revenues in any given year, the deficit will be added to the total

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

cost of the project. As expected, toll revenues fell in the initial years, resulting in capital costs doubling from Rs.4,080 million in 2001 to Rs.9,530 million in 2006.

- The agreement allows the concession to be extended until the concessionaire company has recovered its total costs, entitling it to hold the concession for a maximum of 70 years instead of the 30 years originally envisaged.

- The concessionaire was granted development rights over 30 acres of prime urban land on the Noida territory.

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- The agreement provides no incentives to minimise the 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.

- NOIDA undertook not to build a competing bridge for a period of 10 years or until the DND Flyway reaches its Full Rated Capacity (defined as 16,000 passenger car units during a peak hour), or 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 that finally decided that the project would be implemented by its own company, a clear conflict of interest.

- The concessionaire does not bear any of the risks of unfinished 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.

- Typically, user fees on such infrastructure facilities are determined by state authorities, but this concession agreement gives full power to the private partner to determine user fees.

- 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.

Jumping on the Property Bandwagon

Private equity funds are also investing aggressively in real estate development companies, particularly since the complete opening of the sector 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 securitized debt instruments. Integrated townships are a favourite investor target. 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 is growing at a faster rate than the country's overall economic growth. The returns in certain cities such as Bangalore and Delhi are among the highest in the world. Overall returns in India are 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."[46]

Because domestic real estate companies have a shallow equity base, they are unable by themselves to meet the growing demand, particularly for residential properties, that has been spurred 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 in order to bypass the three-year mandatory lock-in regulation applicable on foreign investments in the real estate sector. Routing their investments through a 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, even though the

[46] Quoted in Vatsala Kamat and Mobis Philipose, "PE in Realty: Shrewd Targeting," *Businessworld*, 14 May 2007.

financial sector has not yet been fully opened for foreign investments. This suggests that private equity investors see great arbitrage value in the financial sector.[47]

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, suggesting huge scope for expansion. Household savings that are invested in financial products represent a mere 18 per cent of GDP.

At the same time, India is creating millionaires faster than any other country in the world, thanks to booming stock markets. According to the *World Wealth Report 2008*, India had more High Net Worth Individuals (HNWI) than any other country, their population growth rate a stunning 22.7 per cent a year, driven largely by market capitalization growth of 118 per cent and real GDP growth of 7.9 per cent.[48] 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) offer 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 (such as equities and mutual funds) and services (for example, wealth management).

Already, the stock broking 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 per annum. Stock markets are likely to expand still further due to reforms that would allow greater involvement by pension funds. This is enticing news for overseas private equity investors partly because, unlike banks, brokers have no foreign ownership restrictions. 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 the business means that such firms, if they want to expand, must either float 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 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, compared to just

[47] Arbitrage means buying and selling the same financial product at the same time but in two different markets in order to profit from price discrepancies between the two markets. Theoretically, the risk of losing money is zero, if the historical differences in prices remain.

[48] Quoted in Vatsala Kamat and Mobis Philipose, "PE in Realty: Shrewd Targeting," *Businessworld*, 14 May 2007.

three in 2006. In the coming months, broking business expansion is likely to be partly driven by the creation of new India-specific funds by foreign institutional investors and hedge funds.

Private equity investors are also looking at microcredit institutions, which have mushroomed in recent years, attracting interest from big banks (such as Citibank and ABN Amro) and some 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 the country, and such investments are expected to accelerate in the coming years for two main reasons. First, the sector has the potential to provide extraordinary returns as some microcredit institutions charge borrowers very high 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 by private equity funds in the 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. For many borrowers, there was little difference between the rate charged by a microcredit institution and that by a traditional moneylender (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 having been harassed by microcredit institutions.

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, starting from April 2009, foreign banks will be accorded "National Treatment" – that is, 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 account[49] would clear the way for even more foreign investments in banking and financial services.

India's Future with Private Equity

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

[49] 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 going through official channels. Capital account liberalization refers broadly to easing the restrictions on capital flows across a country's borders.

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, Evolvence 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 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 that will invest in companies operating in iron ore, mining, forestry, renewable energy and related sectors.

Box 7
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 Blackstone Group – the world's largest private equity firm – in an effort to diversify its overseas investments beyond US Treasury bills and bonds.

China has been grappling with the management of its burgeoning foreign exchange reserves of $1.2 trillion. The deal, which coincided with Blackstone's $4 billion initial public offering, gave China a 9 per cent stake in Blackstone, which owns companies (inclusing Universal Studios and Equity Office Properties Trust) that have close to 350,000 employees.

This investment was carried out by China Investment Company (formally launched in September 2007), which has been authorised to handle a sizeable portion (about $200 billion) of China's foreign exchange reserves. The Company will hold its Blackstone shares for at least four years and is not allowed to invest in a competing private equity firm for a year. The Company (essentially a sovereign wealth fund modelled along the lines of Singapore's Temasek

Holdings) will invest in global financial markets, oil, gas and commodities. The Company will report directly to the State Council of the Chinese government.

The Chinese government's stake in Blackstone took everybody by surprise. This is the first time in history 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, a co-founder of Blackstone, "It's a historic change. It's a paradigm shift in global capital flows."[50]

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The stake in Blackstone is seen as a strategic move by China for several reasons. Firstly, it will help China to diversify its overseas investments and earn better returns than investing in sovereign debt instruments. Secondly, China gets an opportunity to bypass investment restrictions and political opposition in US, as witnessed during the bid by the China National Offshore Oil Corporation (CNOOC) to buy US-based Unocal in 2005. Despite an attractive buyout offer to shareholders, the US Congress opposed the sale of Unocal to state-owned CNOOC on "security" grounds and CNOOC had to withdraw its bid. By investing in a private equity fund, however, the Chinese authorities can indirectly buy into corporations without much attention or political opposition. Closer ties with Blackstone could also earn political dividends in containing the anti-China lobby in Washington.

From a Blackstone perspective, it was a prized deal. At a time when rival 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 other rival players in the buyout business in China. A cosy relationship with the Chinese government will open up new business opportunities for Blackstone.

For the private equity industry as a whole, this deal assures them that there is another pool of capital that they could tap in the wake of the global credit market crunch. If this deal works out well for China and for Blackstone, other sovereign wealth funds may start investing in global private equity funds. No wonder this deal has been watched with much interest by policy makers across the world.

Apart from The Blackstone Group, the China Investment Corporation has also invested $3.2 billion into 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 called China Africa Development Fund in June 2007 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 Fund will be expanded to $5 billion with the participation of other investors.

[50] Quoted in Andrew Ross Sorkin and David Barboza, "China to Buy a Stake in Blackstone," *The New York Times*, 21 May 2007.

Aimed at accelerating economic development in Africa, the Fund is fully sponsored by the state-owned China Development Bank. The mandate of the Fund is to support trade and investment projects of Chinese companies in Africa with a focus on projects related to natural resources, infrastructure, housing, agriculture, manufacturing and industrial parks.

The main businesses of the Fund are equity investment, fund investment, capital and investment management, and consultancy services. But the Fund will not seek majority control or the largest shareholding in the businesses. It will combine a unique structure combining the practices of both global private equity firms and China's state-owned development banks. This Fund is a part restructuring of China's state-owned banks to promote commercial operations. The Chinese authorities are expecting excellent investment returns from the Fund in the long run besides earning international goodwill.

Simultaneously, the Chinese authorities are encouraging the development of the domestic private equity industry in order 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 Chinese 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.

Private Equity's Vulnerabilities

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.[51] 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 pension funds (with 39 and 15 per cent shares). 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. First, private equity firms are not legally required to follow the recommendations of the Report. Second, the recommendations themselves are 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 just a breakdown of investors. Third, 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. 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.

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[51] *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.

• Low Taxation
The private equity industry is also vulnerable to criticism of the tax privileges it gets, particularly "carried interest". These tax breaks have provided the private equity industry's greatest competitive advantage, and despite its public relations offensive, the industry has so far failed to convince policy makers and the public at large why the multi-millionaire partners of private equity firms deserve them, particularly since they already earn so much revenue from management fees.[52]

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.[53] If Washington does impose a tax increase 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 December 2007, the UK's Trade Union Congress proposed a "campaign for fair tax."[54]

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

• Job Losses
After being bought out by private equity, many firms have had to reduce their workforces, slash benefit packages and flout collective agreements with their workers. In August 2005, in one famous case, Gate Gourmet, an airline catering firm then owned by Texas Pacific, sacked 670 staff at London's Heathrow Airport. Staff workers were gathered in a car park to listen to an announcement made by megaphone. British Airways staff at the airport walked out in support of the workers, and mass pickets of Gate Gourmet were organized by labour unions.

Even private equity proponents admit that buyout deals lead to significant job losses, particularly in the initial years, and their counterclaim that buyouts result in the creation of jobs in the long run, particularly quality jobs, is not backed by statistical evidence.

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[52] Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," 9 September 2007 http://www.chicagogsb.edu/research/workshops/finance/docs/metrick-pe.pdf.

[53] The pension funds have been influenced by unions on this issue. In addition, the proposed tax increase would not badly 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.

[54] *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.

Labour unions and union federations, including Union National International (UNI) and Services Employees International Union (SEIU), have led the way in turning the spotlight on job losses. To highlight the destructive impact of private equity buyouts, SEIU organized a global day of action on 17 July 2008, including protests and demonstrations in cities around the world.

• 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 prices 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. A strong policy framework, however, is what is needed.

Political Challenges Ahead

In the US, the private equity industry is politically well organized. Sensing trouble over tax and transparency issues, US-based private equity 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. 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.[55]

In February 2007, US-based private equity firms joined hands to launch the Private Equity Council (PEC),[56] among them Bain Capital, The Blackstone Group, The Carlyle Group, KKR, Providence Equity Partners and Texas Pacific Group. Headquartered in Washington, 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 fact sheets and documents to educate

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[55] In the US, private equity firms have added a new dimension to revolving door politics. Private equity firms are increasingly becoming the employer of choice for ex senior government officials. Instead of working with consulting or lobbying firms for a modest sum, former US government officials are earning huge money at PE firms.
Paul O'Neill, former US Treasury Secretary, joined Blackstone as a special advisor in March 2003. Several 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) have made millions of dollars at Carlyle Group. Mitt Romney, who co-founded Bain Capital Partners, was a Republican candidate for the 2008 US presidential nomination.

[56] http://www.privateequitycouncil.org.

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*.[57]

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. 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.[58]

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 with recommendations on the regulation of private equity made by the European Parliament to the Commission and with 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.[59]

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 to woo the Members of the European Parliament (MEPs). Justifying the Commission's stance, meanwhile, 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."[60]

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

[58] *Developing European Private Equity*, Report of the Alternative Investment Group, July 2006, http://www.evca.eu/uploadedFiles/Home/Public_And_Regulatory_Affairs/PARA_Issues/Issue_Items/4241EC_Expert_Group_on_Alternative_Assets/EU_expert_group(jul06).pdf

[59] Ieke van den Burg and Poul Nyrup Rasmussen, *Hedge Funds and Private Equity: A Critical Analysis*, PSE (Socialist Group in the European Parliament), Brussels, April 2007, http://www.pes.org/downloads/Hedge_Funds.pdf

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

Nor have emerging markets been short of lobby groups representing private equity interests. The Washington-based Emerging Markets Private Equity Association (EMPEA) is an example.

These developments pose new challenges to both analysis and action. For a long time, pressure to liberalize investment in emerging markets came from Northern countries and their investors. 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 equity industry both nationally and internationally.[61] It has yet to be effectively countered in the South 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 the company manipulated the price of some of the bank's shares before closing the deal.

Box 8
Some Key PE Lobby Groups

Private Equity Council (http://www.privateequitycouncil.org)

British Venture Capital Association (http://www.bvca.co.uk)

Private Equity Industry Guidelines Group (http://www.peigg.org)

Institutional Limited Partners Association (http://www.ilpa.org)

European Venture Capital Association (http://www.evca.com)

National Venture Capital Association (http://www.nvca.org)

Emerging Markets Private Equity Association (http://www.empea.net)

India Venture Capital Association (http://www.indiavca.org)

China Venture Capital Association (http://www.cvca.com.hk)

[61] This is not the only such shift to have taken place in financial sector politics. The rise of Southern transnational companies (TNCs) and Sovereign Wealth Funds has also had a structural effect on global capital flows as well.

The Future

Labour unions apart, civil society actors have so far had little input into policy debates on private equity at both national and international levels. NGOs, citizens' groups and corporate researchers have so far 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 is not only desirable but also 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" (alias inadequate national supervision), and a lack of coordination between regulatory bodies were major contributory factors.[62] And 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 be enforced even at the national level.

For either national or international strategies to bring private equity under control, they will have to be a part of 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, energized by locally- or nationally-relevant concerns, for instance, by job losses caused by the private equity industry or the low tax rates paid by private equity investors. In the case of India, where the infrastructure sector currently dominates private equity investments, the questions need to go beyond that of merely whether India needs infrastructure or not. Infrastructure for whom? Who pays? Who benefits?

The subprime mortgage crisis in the US has exposed the strong structural linkages among private equity, securitization vehicles, investment banks and credit rating agencies. The demand for effective regulation of private equity cannot be disentangled from the need

[62] *See* Hildyard, N., *Wall of Money,* forthcoming.

for better regulation of other major financial actors. A unified approach toward regulation of all major players will also be an important topic for the coming debate.

Annex 1
Key Private Equity Players in India

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

1. Temasek Holdings (http://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 Mumbai. Although Indian investments accounted for merely 3 per cent of its portfolio in 2006, the fund is expected to grow rapidly in the coming years, as 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. Recently, 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 premium 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).

2. The Carlyle Group (http://www.carlyle.com), a US-based private equity firm, has been investing in India since 2000, but its large-scale investments have picked up only lately. 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.

3. The Blackstone Group (http://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, in India only in 2005 with a $1 billion investment fund. But of late, Blackstone has been very 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. It announced a target of $1 billion investment in India by end-2007. "Money is not an issue," claims Akhil Gupta, Managing Director of Blackstone Advisors India Pvt. Ltd.[63] Blackstone's investment pattern in India indicates that the firm is more inclined towards buyout deals, as evident in its buyout of Gokuldas Exports Limited (GEL). This was the first buyout of a publicly listed firm in India. This buyout deal gives Blackstone 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 clothing brands such as GAP, Nike and Reebok are GEL customers. Recently, NGOs have documented large-scale violations of workers' rights, especially of women employees, at the firm'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 has also shown interest in buying equity in a nuclear and space science component manufacturing company, MTAR Technologies. If this deal closes, it will be the first private equity investment in India's defence and nuclear sector. The MTAR Technologies has been in the news for a long time because the company faced sanctions in the US when India conducted nuclear tests in 1998.

4. ChrysCapital (http://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. Recently, it has 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 fund management is considering partnering with Indian companies for acquisitions abroad.

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[63] Quoted in Mahesh Nayak, "The Colour of Blackstone," *Business Today*, 23 September 2007.

5. ICICI Ventures (http://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.

6. 3i Group (http://www.3i.com): This 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.

Table 5
Top Ten Private Equity and Venture Capital Funds Raised in India (2006-2007)

Fund	Firm	Corpus ($ million)
IL&FS Realty Fund	IL&FS Investment Managers	525
IDFC Private Equity Fund II	IDFC Private Equity	430
Indivision Capital	Indivision Capital (Pantaloon)	425
Sequoia Capital India Growth Fund I	Sequoia Capital India	400
Kotak India Real Estate Fund II	Kotak Private Equity	350
Ascendas India Development Trust	Ascendas	325
JM Financial India Fund	JM Financial	225
IDG Ventures India Fund I	IDG Ventures	150
Matrix Partners India Fund	Matrix Partners	150
Hellon Venture Partners	Hellon Venture Partners	140

Source: Thomson Financial 2007
Data includes actual funds raised or committed.
Does not include funds announced and in the process of being raised.

Table 6
Top Five Private Equity Investments in India

Investor	Company	Sector	Deal Value ($ million)
Temasek Holdings	Bharti Airtel	Telecom	1,906
Temasek Holdings, Goldman Sachs, others	Bharti Infratel	Telecom	1,000
ICICI Venture	Jaypee Infratech	Infrastructure	800
The Carlyle Group	Housing Development Finance Corporation (HDFC)	Financial services	650
General Atlanti, NYSE, Goldman Sachs, Saif Partners	National Stock Exchange	Financial services	490

Source: Industry reports

Table 7
Carlyle Asia Growth Partners' Investment in India

Date	Company	Fund	Status
June 2007	Eitecore Technologies	III	Invested
May 2006	HDFC	II	Invested
March 2006	Claris Lifesciences	III	Invested
October 2004	Newgen Imaging Systems	II	Invested
October 2003	LearningMate Solutions	I	Invested
May 2003	QuEST	II	Invested

February 2003	Worldzen Holdings	II	Exited
November 2000	Financial Software & Systems	I	Partially exited
October 2000	SSKI Investor Services	I	Exited

Compiled from news reports and company documents

Table 8
Recent Deals by The Blackstone Group in India

Target company	Value ($ million)	Type
Intelenet Global	200	Management buyout
Gokaldas Exports	165	Buyout
Nagarjuna Construction	150	Minority stake

Source: News reports

Table 9
Estimated infrastructure investment requirements
($ billion at 2005-2006 prices)

Sector	Estimated requirement
Power	130
Railways	66
National highways	49
Civil aviation	9
Ports	11
Residual sectors*	53

* including telecoms, SEZs, supporing urban infrastructure, water and sanitation, rural roads, logistics and pipelines.

Annex 2
Resources on Private Equity

Several sources (print and online) provide information, analysis and databases on the global private equity industry. Most of these sources are commercial and therefore expensive to gain access to. 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)**, ***European 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.

In addition, 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 online resource providing wide news coverage and analysis on M&A, private equity and venture capital. It brings out a number of daily, weekly and monthly newsletters besides providing 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 Clearinghouse (www.privateequity.com) is a search directory of online information, website links and other sources serving private equity firms and institutional investors.

AltAsset (www.altassets.com) is an online 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 online library of information in the form of hundreds of articles and reports aggregated 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 online.

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

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.

Other important sources of information are 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 (SEIU)** has also published a report titled, ***Behind the Buyouts: Inside the World of Private Equity*** in April 2007. This report as well, as other information, is available at its website exclusively devoted to buyouts deals **(www.behindthebuyouts.org)**.

In May 2007, **International Union of Food Workers** published ***A Workers' Guide to Private Equity***. It has also created an exclusive website called IUF's Private Equity Buyout Watch **(www.iuf.org/buyoutwatch)** which contains a lot of 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 titled *Where the House Always Wins: Private Equity, Hedge Funds and the New Casino Capitalism* (**www.ituc-csi.org/IMG/pdf/ITUC_casino.EN.pdf**). The report 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. Apart from various statements and documents, the PES has also 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 also available on several blogs.