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Private equity

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Summary

Our inquiry was undertaken in response to the growing significance of the private equity industry in the UK (8% of the UK workforce is now employed in private equity-owned companies), and, in particular, to the rising number of takeovers of very large companies by private equity firms. We have concentrated on the highly-leveraged management buy-in and buy-out sector. Our report is an interim one.

We examine the respective advantages and disadvantages of private equity and public limited company (PLC) ownership, and conclude that there are benefits and potential problems associated with each, and that different forms of ownership may be appropriate for a company at different times in its history. There remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation.

Many of our witnesses highlighted the disadvantages of PLC status. We invite major corporate investors to re-examine why their requirements of PLCs and of private equity-owned companies are so different.

We note the need to ensure that company pension fund commitments are securely funded, especially when changes, such as an increase in leverage, are made to a company.

We note that, however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk; that this becomes more significant the more important highly-leveraged firms become in the economy; and that the trend towards greater leverage has occurred during a period of economic growth and stability, which is not guaranteed to continue. We therefore urge the Bank of England to research the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy. We also recommend that the Financial Services Authority continues to seek assurance that the banking system has the appropriate structures and monitoring in place to handle the risk associated with banks' exposure to leveraged buy-outs.

We welcome Sir David Walker's proposals to increase transparency in the private equity industry, and would like to see more detailed guidance on some aspects of the information to be provided. We also suggest additional independent monitoring of the industry's conformity with the proposed code in order to provide greater assurance of compliance. In addition, we invite Sir David to consider whether more information could be made available on fees in order to make the private equity market more competitive.

Given the conflicting views expressed about whether the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) apply to takeovers, we ask the Government to clarify this.

We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their current review of taxation in this area, and we request information about the purpose and current operation of the Memorandum of Understanding.

We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged management transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions. Whilst recognising that the issue is not exclusive to private equity, we also ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, and note that the Treasury and HM Revenue and Customs need to demonstrate a rigorous approach towards claims of non-domicile status.

The central issue remains what impact the current activities of the private equity industry, especially the larger private equity firms, are having on the UK economy as a whole. We will return to the matter in the autumn. It is clear that there are areas of concern which deserve continued attention from policy-makers.

1 Introduction

Our inquiry

1. On 20 March 2007, we announced an inquiry into the private equity industry, as part of our work on the theme of "Transparency in Financial Markets and the Structure of UK plc". Our inquiry was undertaken in response to the growing significance of the private equity industry in the UK, and particularly the rising number of takeovers of very large companies by private equity firms. These are a new phenomenon; the recent £11 billion purchase of Alliance Boots was the first takeover of a FTSE 100 company by a private equity firm. The increasing size of private equity deals raises a range of issues, relating for example to the impact of private equity on jobs, pensions, financial stability, transparency and accountability and tax revenues.

2. As well as gathering written evidence, we held three evidence sessions in June and July: the first with academic experts, with the TUC and the Work Foundation and with the British Private Equity and Venture Capital Association (BVCA); the second with trade unions, private equity firms and financial industry bodies; and the third with Sir David Walker, Chairman of a working group on transparency in the private equity industry, the Financial Services Authority (FSA) and private equity firms. We are grateful to all those who gave evidence or otherwise assisted our inquiry.

Scope of the inquiry

3. The term "private equity", meaning the equity financing of companies not quoted on the stock market, covers a wide range of businesses, from small venture capital firms to large portfolio companies. According to the Work Foundation, the term

> refers to both 'seed capital' used to fund a new start-up business and to the funds used to buy a company out of public ownership or out of a larger subsidiary. … Deals tend to be [of] two general types – management buy-outs (MBOs) and management buy-ins (MBIs). In the former the existing management raise the funding the take the company private and in the latter the management comes from outside.[1]

Wol Kolade, Chairman of the BVCA, indicated that there are about 1,500 private equity deals per year, of which only a very small number are high profile.[2] During our inquiry we have concentrated on the highly-leveraged management buy-in and buy-out sector, and particularly the larger private equity firms, rather than the venture capital or management buy-out sectors. We emphasise that we do not start from a position of preferring one form of company ownership over another.

4. Our inquiry has coincided with increasing interest more generally in the private equity industry. In November 2006, the FSA issued a discussion paper on private equity, focussing

1 *Inside the dark box: shedding light on the private equity industry*, Phil Thornton, the Work Foundation, March 2007, p 9

2 Q 120

on "risk and regulatory engagement",[3] and it published a summary of the responses in June 2007.[4] In March 2007, the BVCA announced the formation of a working group under the chairmanship of Sir David Walker to review the adequacy of disclosure and transparency in private equity, with a view to recommending voluntary guidelines.[5] Sir David reported his interim proposals on 17 July,[6] and is expected to produce final proposals in autumn 2007. The then Economic Secretary to the Treasury, Ed Balls MP, announced on 3 March 2007 that the Government "would review the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals" and would report the outcome by the time of the Pre-Budget Report.[7] The Treasury has since indicated that the Government is also reviewing the taxation of a range of employment-related securities.[8]

5. Given the limited time available to us before the summer recess and the various other studies under way, including Sir David Walker's review, we decided to make our Report an interim one. We do not, therefore, make detailed recommendations in this Report, but we are pleased to have been able to gather a body of evidence which dispels some of the mystery surrounding private equity and which we hope will contribute to the wider debate. We will return to the subject in the autumn.

6. Our report discusses:

- The nature of the private equity industry;
- The differences between the private equity model and the PLC model;
- the possible risks to financial stability posed by recent developments in private equity;
- the issue of transparency as regards both private equity firms and the companies they take over; and
- tax, especially the taxation of "carried interest" and of debt and equity.

3 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006

4 *Private equity, a discussion of risk and regulatory engagement*, FS07/3, FSA, June 2007

5 '*Sir David Walker to chair private equity working group on disclosure*', BVCA press release, 1 March 2007

6 *Disclosure and Transparency in Private Equity: Consultation document July 2007*, Sir David Walker, July 2007

7 Speech by the former Economic Secretary to the Treasury, Ed Balls MP, to the London Business School, 8 March 2007

8 Ev 184

2 The private equity industry

The size of the industry

7. Currently 8% of the UK's workforce (1.2 million workers) is employed in private equity-owned companies and 19% work in companies which have at some stage been in private equity ownership.[9] According to the CBI, private equity firms helped to "generate £3.3 billion in fees for supporting organisations in 2005 which equates to more than 7% of the total annual turnover of the UK financial services industry".[10]

8. The UK is the largest market for private equity outside the US and the largest and most developed in Europe, accounting for over half of total European private equity investment in 2005.[11] In 2006, UK-based private equity fund managers raised £33.64 billion out of a global total of £223.24 billion raised by such funds.[12]

The growth of the industry

9. As the table below (contributed by the FSA) shows, the value of private equity funds in the UK has grown significantly since 2003. However, this growth has been less marked than in other countries. For example, the value of funds raised in the US between 2003 and 2006 increased more than six-fold, compared with a trebling in the UK over the same period. As a result, the proportion of the global total of funds raised accounted for by the UK has fallen from 27% in 2003 to 15% in 2006.[13]

Funds raised by year of final close (£ billion)

Year	Asia	Europe excluding-UK	Other	UK	US	Global total
2003	0.40	6.18	0.97	11.69	24.31	43.54
2004	2.78	9.50	3.00	12.10	65.47	92.84
2005	4.11	14.64	5.90	33.52	102.17	160.34
2006	8.19	23.97	5.37	33.64	152.07	223.24

Source: Ev 236

10. The debate on the private equity industry in the UK has arisen principally as a result of the increase in deal size, rather than the number of deals. As the chart below shows, while the number of buy-outs and buy-ins valued at under £5 million was the same in 2006 as in 2000, the number valued at over £250 million increased from 17 to 25.

9 Ev 84; Q 43

10 Ev 154

11 *The economic impact of private equity in the UK*, BVCA, November 2006, p 5

12 Ev 236

13 Ibid.

Value ranges of private-equity backed UK buy-outs/buy-ins – Number of deals

Deal Range	2000	2001	2002	2003	2004	2005	2006
Less than £5m	99	95	80	75	86	95	99
£5m - £10m	36	40	31	32	21	24	24
£10m - £25m	70	55	44	43	51	46	51
£25m - £50m	23	34	22	31	37	38	40
£50m - £100m	27	15	19	23	27	25	35
£100m - £250m	23	18	11	11	30	26	30
Over £250m	17	12	13	9	13	23	25
Total Number	295	269	220	224	265	277	304

Source: Ev 235

11. Looking at leveraged buy-outs[14] alone, completions in the first half of 2007 were over £25 billion, close to the full-year record in 2006 of £26.5 billion. The Alliance Boots deal alone accounted for over £11 billion and, as indicated above, was the first buy-in of a FTSE 100 company. The total value of public to private buy-ins in the first half of 2007 was a record £14 billion, compared with around £6 billion in 2006.[15]

Typical fund structures

12. Private equity funds are the pools of equity invested by private equity firms.

- Most of this equity is provided by domestic and overseas institutional investors, such as pension funds, charities, not-for-profits, public authorities, insurance companies, endowments and private investors.[16]
- Partners in the private equity firm typically provide 1.5 to 5% of the equity in a private equity fund, to give assurance to the institutional investors that their interests are aligned.[17]
- The lifetime of a fund is usually around 10 years,[18] during which it undertakes a number of investments, each of which has a duration of around three to five years.
- Private equity firm partners usually take an active role in the management of the company or companies which the fund invests in.
- The fund may be used alongside debt to purchase a public company or a division of a public company (or several companies) and take it private, i.e. a management buy-in (MBI).
- The value of the equity stake in the company usually equates to around 30 per cent of the value of the target company, with the remaining 70 per cent provided as debt. The debt is typically provided by investment, commercial and retail banks.[19] The banks may then distribute large proportions of this debt to other institutions—either other banks

14 Management buy-ins are a type of leveraged buy-out (LBO).

15 Centre for Management Buy-Out Research (CMBOR)

16 Ev 200

17 Ev 250. See also Q 584

18 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 3.3

19 Ev 92

or institutional debt market participants, such as CLO (collateralised loan obligation) managers and CDO (collateralised debt obligation) managers.[20]

- The private equity firm usually receives an annual management fee of around 2% of the value of the fund, though this has apparently declined for the larger funds to 1.5 or 1.75%.[21]

- When the company is re-sold around three to five years after purchase, the institutional investors who have invested in the private equity fund receive the first cut of the profit, an agreed target rate of return or hurdle rate, which is usually 8 to 10% compounded per annum. The private equity firm partners are usually entitled to 20% of the profit above the hurdle rate, while the other investors will receive the remaining 80%. This 20% of the profit above the hurdle rate is referred to as "carried interest" or "carry" and is taxed as capital gains (see Chapter 6).[22]

13. As previously indicated, we are principally interested in the large management buy-in and buy-out sector of the private equity industry. In the case of a management buy-in of a large public company, the private equity firm will raise debt alongside the private equity fund in order to finance the purchase of the target company. The private equity firm will then usually set up a number of holding companies between itself and the target company which are used as vehicles for debt of different types. This enables the debt providers to obtain the precise degree of exposure to the target company they require. Recently, the payment terms for these loans have become less demanding, through, for example, covenant-lite loans (see Chapter 4) and Payment-in-Kind (PIK) notes.[23]

Rates of return

14. Evidence on the returns achieved by private equity is mixed. According to IFSL,[24] the return on private equity as a whole has been more than 16% a year over the ten years to 2005.[25] This has exceeded the returns on a number of other asset classes, including property, UK bonds and equity, and overseas bonds and equity.[26] However, in the case of the US, according to research by Citigroup, if US mid-cap companies had had similar degrees of leverage to buy-out funds, returns would have exceeded those achieved by private equity.[27] Other evidence from the US is that the returns achieved by private equity funds and venture capital together were similar to average returns on the stock exchange

20 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 1.2

21 Qq365-9

22 The term '2 and 20' is often used to refer to the usual 2 per cent annual management fee and the 20 per cent carried interest stake.

23 In the case of a corporate bond, PIK means that the bond issuer will cover the interest payments on the bond by issuing further debt rather than paying cash.

24 International Financial Services, London

25 *Private Equity: City Business Series, October 2006*, International Financial Services, London

26 *Inside the dark box: shedding light on private equity*, Phil Thornton, the Work Foundation, March 2007, p 18

27 Ibid., p 19

once fees were excluded; looking at buy-outs alone, returns net of fees were lower than those on the stock exchange.[28]

Future prospects for private equity

15. We asked several witnesses from private equity firms how they would characterise the private equity market at present and its likely development. Donald Mackenzie of CVC Capital described it as "buoyant, as good as it has ever been",[29] while Jon Moulton of Alchemy indicated that it was "near its top".[30] Mr Mackenzie expected "the number of deals being done to continue at the sort of growth rate we have had in the last few years", whereas Mr Moulton believed that the UK market would "probably continue to do roughly the same number of deals", and David Blitzer of Blackstone considered that "the size of transactions over the next few years will not increase at similar rates to what we have seen over the last three or four years … I think you will see a similar number of transactions".[31]

28 *Unhappy returns to investors in private equity*, David Hall, Principal Lecturer and Director of PSIRU, Business School, University of Greenwich, June 2007, p 2

29 Q536

30 Q538

31 Q540

3 Private and public equity models compared

Advantages and disadvantages of private equity

Introduction

16. Much of the evidence we received related to the respective merits of private equity and public equity, both for the companies concerned and for the wider economy and society. We list here the advantages and disadvantages of private equity relative to public equity as stated in the evidence we received (in several cases reflecting opposing views), before examining them more closely.

Advantages

- Shorter chain of ownership, with partners taking an active role in the running of the company;
- Longer investment horizons (as explained in paragraph 21);
- Fewer reporting requirements;
- Ability to provide better incentives for managers;
- Greater ability to create jobs because better at creating successful companies with a long-term future.

Disadvantages

- Conflicts of interest, because private equity partners involved in the running of companies may have different priorities from other investors in the private equity fund;
- Shorter investment horizons, because the aim is usually to sell the company after a few years, rather than focussing on long-term growth;
- Lack of transparency, making them less accountable to the public and their workforces;
- Greater leverage, making companies more vulnerable to economic downturns and with the potential to pose risks to lenders and the financial system;
- Risk of job destruction through seeking to extract value;
- Risk to pensions, through selling assets and loading companies with debt.

Of these, we discuss risks to the economy in Chapter 4 and transparency in Chapter 5.

Chain of ownership

17. One key benefit claimed for private equity is the more streamlined management structure, with a better flow of information. The Treasury stated that "the chain of ownership and communication is relatively short, giving the owners of capital much clearer direction of the businesses which they are financing than under some other forms of ownership."[32] Philip Yea, Chief Executive of 3i Group plc, observed that a private equity practitioner understood the potential efficiencies and the risks facing a company because he sat on the board, whereas in a PLC a diverse group of shareholders without that understanding had to be persuaded.[33]

18. The Institute of Chartered Accountants in England and Wales (ICAEW) told us that it was easier to align the interests of managers and owners in a private company, because "A publicly listed company with a diffuse shareholder base needs to address potential agency conflicts through adherence to corporate governance norms and will invest significant time and money in communicating with shareholders, investor relations and periodic reporting. By contrast, management of a private equity-backed company has more opportunity to focus on strategy."[34] Mr Mackenzie said that on the boards of public companies "there is an awful lot of time spent on regulation, new rules coming up, the latest corporate responsibility statement and so on and so forth, and not enough time on, 'What are we going to do over the next five years to grow this business and make it more profitable?'"[35] Mr Moulton added that if "you have got 20 people on the board, 12 of them non-executives, [it] is not actually a very good predicator of good management".[36] According to Legal & General Ventures Limited, "The fact that a longer term view of a company's prospects can be taken in the absence of pressure from City investors means that operational improvements which might affect short-term profits can be made."[37] Part of the advice from Mr Blitzer to PLCs was "to make the right long-term decisions for the company and the business without regard to short-term earnings performance. I would make sure that the executives within the business were focusing less time on the City and on board preparation; again, much more time on driving the business … We find a lot … that they have terrific ideas but at the end of the day they do not implement them because they think it is too high a risk level or it is not what their shareholders want."[38]

19. Better, more strategic management ought to be reflected in more successful companies, but here the record appears to be mixed. There is not much of a track record for very large UK-based firms owned by private equity because these are a recent development. For the sector in general, Paul Myners observes that private equity ought to produce higher returns because of its greater risk, but has not always done so, and referred to evidence suggesting that "on average private equity funds have produced inferior returns to public equity funds over most periods … The best private equity funds have produced very good returns; a

32 Ev 183

33 Q 347

34 Ev 234

35 Q 616

36 Q 619

37 Ev 152

38 Q 582

significant number have disappointed, some very badly."[39] Professor Jenkinson suggested that private equity was not "a magic wand that you wave over companies, but at its best it is transformational in an extraordinarily short space of time, in a way which probably could not be done necessarily under the gaze of the public markets".[40] As Mr Mackenzie indicated, private equity tends to take over under-performing public companies, and rarely the out-performers.[41]

20. There are also concerns about conflicts between the responsibilities a private equity fund manager has to itself, to the investors in the separate funds and to the companies owned by the funds, which we discuss in Chapter 4. The Treasury warned investors in private equity funds to be "vigilant about any potential for misalignment of incentives".[42]

Investment horizon

21. The Treasury stated that private equity firms own companies for three years on average, which is 20 per cent longer than the average length of time institutional investors hold shares in public companies.[43] Others suggested that the typical length of private equity ownership was about three to six years.[44] The trade unions believed that this typical time horizon encouraged a short-termist approach to investment, and that owner-managers intending to exit an investment after three to five years were likely to look less favourably on investments that would deliver outside this time-frame. The GMB added that the "taper relief" (discussed in Chapter 6) available after two years "specifically encourages short term investment, which we believe is not conducive to good management of a company".[45] The ICAEW believed there was "scope for further research on the impact of developments in private equity on long-term business investment, for example, in R&D and training".[46] The Association of British Insurers (ABI), while seeing no reason in principle why private equity owners should behave differently from quoted companies as regards the long and short terms, noted "a legitimate concern that risky financing structures with high levels of debt make the ability to realise cash through asset disposals more important creating a bias towards inefficient economic decision-making for the longer term, but which is made good by the tax benefits of high levels of debt finance at the start."[47] The ABI also noted that institutions sometimes keep their core holdings in public companies for many years, and Paul Myners believed the data on average holding periods for public equity was "severely distorted by the impact of algorithmic and programme trading".[48]

39 Ev 198
40 Q 12
41 Q 616
42 Ev 183
43 Ev 183
44 Ev 102
45 Ev 99
46 Ev 233
47 Ev 138
48 Ev 138, 198

22. On the other hand, many private equity firms, academics and industry bodies who gave evidence emphasised the benefits of what they saw as the longer-term horizons of private equity firm investors compared with investors in public companies. For example, Professor Tim Jenkinson of the University of Oxford referred to the "sense of urgency" that could be injected into companies by "buy to sell" private equity investors, and pointed out that "the things that you do to create value on exit have to be things which are good in the long term".[49]

23. We agree with the view that in order to be able to sell a company on, private equity investors have a strong incentive to ensure that a company has good prospects in the longer term, though, just as in a public company, investors will be balancing future benefits and likely receipts from the sale of companies against the present costs of longer-term investments. We believe this is one of the areas in which further research is needed, particularly on the relative impact of private and public equity in areas such as R&D and training.

Reporting requirements

24. Unlike quoted public companies, private-equity owned businesses are not subject to the reporting or corporate governance arrangements of stock exchange listing, such as the requirement to publish six-monthly earnings statements, and need only publish their annual report nine months after the year-end.[50] From October 2007, all quoted companies will have to include in their business review the directors' view of "the main trends and factors likely to affect the future development, performance or position of the company's business". For public companies, but not private ones, information on the company's employees and suppliers, on environmental matters, on social and community issues and on company policies relating to these areas (and their effectiveness) must also be included. We examine this question of disclosure and transparency in Chapter 5.

Incentives

25. Witnesses from private equity firms argued that, because they did not have to publish salary details or seek approval from shareholders, private equity firms were able to offer greater incentives to managers than public companies could and thus to "incentivise" them to perform better. Professor Jenkinson told us that managers "may be asked to put a few hundred thousand of their own money into the business and then, if they are successful, they can walk away in three years' time with many millions of pounds",[51] adding that "public market investors are more sensitive to the pay of their executives than are private equity companies".[52] There is also an argument that the rewards of private equity partners are excessive and are the result of "value extraction" rather than "value creation".[53]

49 Qq 11, 16

50 Note that there is no difference between the reporting requirements for private equity-owned companies and other privately-owned companies, such as family businesses.

51 Q13

52 Q14

53 Q18; Ev 113

Leverage

26. Private equity takeovers of public companies often involve greatly increasing the amount of debt on the balance sheet of the companies being taken over. This is reflected both in ratios of debt to earnings and ratios of debt to equity. According to the Bank of England, "Higher corporate borrowing has partly been the result of private equity buyouts" and "Maximum debt levels for European LBOs [leveraged buy-outs] are now consistently above seven or eight times earnings, whereas the maximum was around six times earnings a year ago".[54] The FSA referred to its survey of leveraged buy-outs which showed the debt/EBITDA[55] ratios of the banks' five largest transactions in the twelve months to June 2006 was 6.41 which it described as "a high figure relative to both leverage levels observed in large deals historically and leverage levels typically observed today in smaller transactions".[56] As regards the ratio of debt to equity, a rule of thumb widely used is that this is typically 30:70 for public companies and 70:30 for private equity-owned companies.[57]

27. There was general agreement that greater use of debt lowered the cost of capital.[58] The question is then why there is more use of debt in private equity firms than public companies. The reason given by private equity firms was that investors in private equity have a better understanding of the companies in which they are investing, and so are comfortable with a higher level of debt. Philip Yea of 3i Group said that "a single shareholder who has spent millions of pounds understanding the potential of a company and put great resources into exploiting it is very well placed to decide where the efficient frontier is", unlike shareholders in a private company who may not understand the reason for the degree of leverage.[59] Professor Jenkinson argued that the expectation of stable and predictable dividends from public companies made it hard for them to become more leveraged, because it was "very difficult … to maintain a constant dividend stream or a constant growth of dividends if you have a very highly-leveraged structure because, by its very nature, the residual profits tend to go up and down quite a lot with interest rates and with changes in the economy".[60]

28. As Professor Jenkinson's observation indicates, a consequence of greater leveraging may be increased risk. Daniel Godfrey of the Association of Investment Companies (AIC) pointed out that public companies with less debt "are likely to be able to ride recessions better than companies that are very highly geared".[61] Professor Karel Williams of the University of Manchester and others provided the results of a simulation which showed an increase in the volatility of returns to equity in FTSE 100 companies (but also higher returns in most years) if their debt:equity ratio changed from 30:70 to 70:30.[62] Paul Myners

54 *Financial Stability Report*, Bank of England, April 2007, p 19

55 Earnings before interest, tax, depreciation and amortisation

56 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, p 7

57 Ev 115

58 e.g. Q81

59 Q347

60 Q5

61 Q 442

62 Ev 116. See also para 45 below.

argued that the increased indebtedness associated with private equity takeovers "is likely to be associated with increased risk for some or all of employees",[63] and a similar point was made by Jon Moulton of Alchemy.[64] The FSA referred to the possibility of jobs in "over-leveraged" private equity companies starting to look "increasingly precarious", [65] and also identified potential risks to lenders and to financial stability if such lending turned out to be imprudent,[66] a matter we discuss in Chapter 4. Another important aspect of debt and private equity is whether high levels of debt are unduly favoured by the tax system, and we consider this in Chapter 6.

Job creation and destruction

29. We received many individual examples of job creation and job losses in private equity-owned firms, but meaningful overall figures are elusive. The BVCA told us that "Over the past 5 years, jobs and sales in private-equity backed companies have grown faster than in FTSE 100 and FTSE 250 companies (9 per cent per annum on average as compared with 2 per cent)". It also referred to a survey conducted by the Financial Times in April 2007, which "analysed the thirty biggest private equity deals concluded during 2003 and 2004, and found that 36,000 new jobs had been created—an increase of 25 per cent".[67] However, Dr Tony Golding cautioned us against using the BVCA's figure of 9% employment growth per year on average in the five years to 2005–06, arguing that the figure was not weighted by size and the large number of small firms invested in by BVCA members skewed the results.[68] The Work Foundation concluded that MBOs, where the existing management raise the equity needed to take a company private, had a more beneficial impact on employment than MBIs, where a new management comes in, although it added that, in cases such as the AA, where significant job losses occurred, it was unclear what would have happened to employment if there had not been an MBI or MBO.[69]

Pensions

30. Concerns about pensions following private equity takeovers relate to the increased debts, reduced assets and thus increased risks which can follow such takeovers, and to the perceived attitude of private equity owners towards their staff. The GMB told us of its concerns regarding the reorganisation of pension funds and the use of pension funds to secure debt following private equity takeovers.[70] Jack Dromey of Unite (T&G) referred to evidence from Standard & Poor which was "absolutely clear that the impact of leveraged buyouts is to depress pay and conditions of employment and pensions".[71] Paul Kenny of GMB referred to the transfer of pension fund liabilities to the taxpayer via the Financial

63 Ev 199

64 Q623

65 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 4.22

66 Ibid., p 7

67 Ev 84

68 Ev 182. See also Q182

69 *Inside the dark box: shedding light on private equity*, Phil Thornton, The Work Foundation, March 2007, pp 15-16

70 Ev 98

71 Q 182

Assistance Scheme, although it was not clear that all the examples provided related to private equity takeovers.[72]

31. For the private equity firms, Wol Kolade of the BVCA pointed out that "Private equity operates under the same rules and the same pensions regime as any other public company". Peter Linthwaite, then of the BVCA, added that "We have in place … a regulator who has a pre-clearance system which allows the trustees and the potential acquirer to discuss the appropriate level of funding … of the pension fund".[73] Private equity firms also highlighted the benefits to pension funds which have invested in private equity,[74] although this is a separate issue.

32. As a remedy for company pension schemes in the face of private equity takeovers, and referring to Boots as an example, Paul Kenny of the GMB suggested that "the trustee should have specific powers to block or call in the regulator on those deals".[75] Unite (Amicus) suggested that "substantial up front assets are required to ensure protection of any scheme"[76]. Unite (Amicus) also suggested that pension scheme obligations should be ranked ahead of bank lenders in the event of company insolvency, and change of ownership in any form should be scrutinised by the pensions regulator.[77] Unite (T&G) told us about the existing rights of pension trustees "to demand guarantees, often in the form of up-front cash payments, to secure the financial commitments of the pension fund to its beneficiaries".[78] **We accept that ensuring** that **company pension fund commitments are securely funded is a vitally important matter when major changes are made to the structure and financing of a company, especially when such changes include an increase in leverage and thus increased risk to pension funds, and we will return to this matter when we resume our inquiry into private equity.**

Public or private equity?

33. The private equity firm, Blackstone, stated, "The type of ownership that suits a company will depend on the nature and age of a business as well as its management's aspirations. This is why many firms switch from public to private ownership and back again."[79] Similarly, the then Economic Secretary to the Treasury, Ed Balls MP, said in March 2007:

> From the point of view of the health of the British economy – no particular form of ownership is inherently to be preferred over any other… The real issue for investors, for the health of the company concerned, for those workers whose jobs depend on

72 Qq 181, 184, 194-9, 206

73 Q 110

74 Qq 252, 591

75 Q 187

76 Ev 103

77 Ev 106

78 Ev 241

79 Ev 189

> the health of the company's success, and ultimately for the economy as a whole, is how effectively that ownership is exercised.[80]

On the basis of the evidence we received, **it is clear that there are benefits and potential problems associated both with private equity and public equity, and that different forms of ownership may be appropriate for a company at different times in its history and for different companies. We also accept that the central issue will usually be how effectively the company is being managed. There remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation. Also, we note that for some of the issues discussed in this chapter the available information, especially on the effects of management buy-ins, is patchy and these issues need further investigation.**

34. Many of our witnesses in this inquiry have highlighted the current disadvantages of the PLC model, resulting from the pressures placed on PLCs chiefly by their shareholders. Given the continuing importance of PLCs to the UK economy, this is a cause for concern. As Paul Myners points out:

> The ultimate investors in private equity are the same ultimate investors in public equity – the pension funds of companies, not-for-profits, public authorities, insurers, endowments and private investors. These investors should ask why they invest in private equity with its association with aggressive capital structures, high incentives for management and a minimalist approach to governance … while adopting an entirely different set of approaches when investing in public equity. … Determination of the most efficient form of financing (use of debt) should not be a function of the form of ownership and yet it appears to be.[81]

It is not unreasonable for institutional investors to want to invest in different asset classes with different characteristics in order to diversify their portfolios, but in wider economic terms, it is not obvious why companies which may be similar or be operating in similar markets should be treated in such different ways by their owners. **We invite major corporate investors to re-examine why their requirements of PLCs and of private equity-owned companies are so different, and we will take further evidence on this in the autumn.**

80 Speech by the Economic Secretary to the Treasury, Ed Balls MP, London Business School, 8 March 2007

81 Ev 200

4 Economic Risk and Financial Stability

Introduction

35. Issues relating to economic risk and financial stability have been examined by the FSA and the Bank of England. The FSA issued a discussion paper, *Private equity: a discussion of risk and regulatory engagement*, in November 2006,[82] and published responses to the paper in June 2007.[83] The discussion paper summarised the FSA's concerns as follows:

Significance	Risks
High	Market abuse, conflicts of interest.
Medium high	Excessive leverage, unclear ownership of economic risk.
Medium low	Market access, market opacity.
Low	Reduction in overall capital market efficiency

"Significance" reflects both the probability of the risk materialising and the potential impact.

Market abuse and conflicts of interest

36. As regards market abuse, the FSA was concerned about the flow of price sensitive information relating to private equity transactions.[84] As the complexity of the transactions increase and more parties become involved, the flow of such information is likely to increase. Public to private transactions pose particular risks due to the number of participants involved in a transaction.

37. As for conflicts of interest, the private equity firm model involves managers of the firm putting their own capital into a fund to ensure that their interests are aligned with the other investors, but interests may become misaligned in a number of situations, which the FSA's paper sets out or which were mentioned in responses to the paper:[85]

- When managers from the private equity firm are able to over- or under-commit to particular deals, for example through co-investment,[86] causing the weight of particular companies in their portfolios to differ from that for other investors, such that there are conflicting incentives as to the effort they should apply to their management of different companies.

- When one manager in a private equity firm runs several different private equity funds at different stages in their investment cycle, so that, if both funds have investments in the same company, they may have diverging interests concerning the best time to sell.

82 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006

83 *Private equity: a discussion of risk and regulatory engagement*, FS07/3, FSA, June 2007

84 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, p 8

85 Ibid., pp 72–4

86 A co-investment vehicle enables investors to make an additional investment above that made by the fund.

- When a private equity fund manager is also managing hedge funds or collateralised loan obligations (CLOs)[87] and these may be used to warehouse debt from a private equity transaction that other market participants were unwilling to take on.
- When an employee or partner of a fund manager also has a seat on the board of a company owned by the fund.
- When a private equity firm pays fees to its own subsidiary during a purchase or disinvestment, creating a conflict between the interests of the limited partners and the private equity firm.
- When, during an MBO, the existing management receives financial backing from a private equity fund to take a public company private, creating a conflict between the interests of the managers and shareholders of the public company.

38. Several of our witnesses from private equity firms and industry bodies disagreed that market abuse and conflicts of interest warranted being labelled as high risk and emphasised the internal controls they had to mitigate such risk.[88] Philip Yea of 3i Group referred to an internal conflicts committee and clear internal standards for dealing with market abuse and conflicts of interest, and Dominic Murphy of KKR told us about the importance of having "a reputation for a high degree of integrity".[89] David Blitzer of Blackstone agreed that market abuse and conflicts of interest were "extremely serious issues, should be high on the FSA's agenda and is something we focus on a great deal at our firm and within the marketplace".[90]

39. Following the consultation, the FSA concluded that "the risk of market abuse presents significant detriment to our statutory objectives with respect to the prevention of financial crime, consumer protection and, if not mitigated, overall market confidence. We will therefore maintain our focus on market abuse in the context of private equity transactions."[91]

40. On conflicts of interest, the FSA "continue[s] to perceive conflicts of interest as an area of significant risk within private equity markets." While the FSA refers to the potential mitigation of conflicts of interest through firm's own structures and systems, legal contracts and "proactive ongoing supervision work", it is clear that it remains to be convinced as to the effectiveness of these. The FSA says that "This will remain an area of supervisory focus for all authorised firms involved in private equity markets. We intend to carry out further thematic work in this area."[92] **We welcome the work the FSA has carried out on the risks relating to market abuse and conflicts of interest in private equity markets, and its intention to carry out further work. We would be interested in receiving evidence on the incidence of market abuse or conflict of interest issues arising**

87 A CLO is a special purpose vehicle to which a bank transfers its loans. The CLO will collect a number of commercial loans, and repackages them into tranches of rated debt securities.

88 Qq 273–4

89 Qq 273–4, 276

90 Q 545

91 *Private equity: a discussion of risk and regulatory engagement*, FS07/3, FSA, June 2007, p 18

92 Ibid., p 7

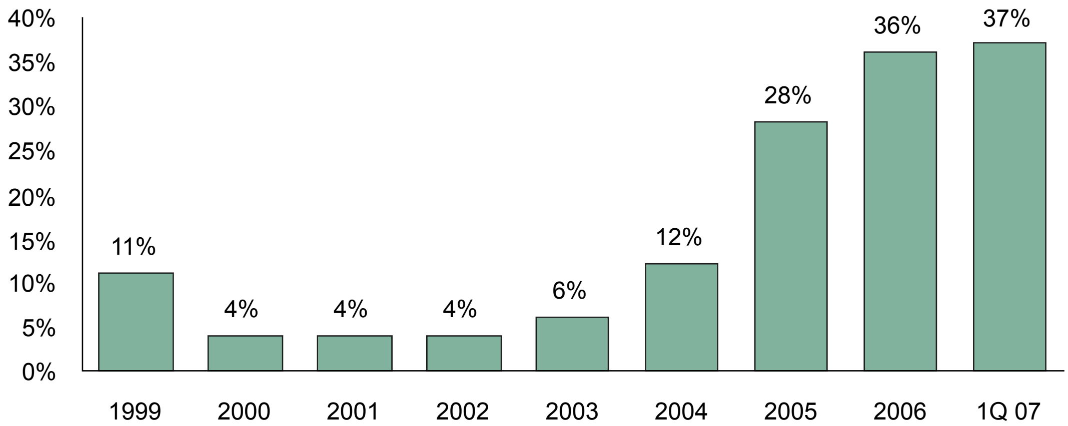
within private equity transactions or funds compared with public company transactions or investment funds. We will return to these issues as part of our work on the theme of transparency in financial markets.

Leverage and economic risk

The increase in leverage

41. As already discussed, recent private equity deals have increasingly been characterised by a high degree of leverage. The chart below shows that the frequency with which the debt to EBITDA[93] ratio in European leveraged buy-outs has exceeded 6.0 has increased significantly since 2004.

Proportion of European leveraged buy-outs (by volume) with debt/EBITDA above 6.0 times



Source: Ev 227

42. Leverage has been increasing for a number of reasons:

- The benign macro-economic environment has supported company profitability and the ability of companies to service debt, and has reduced the risk of default;
- The price of credit has been extremely low, reflecting factors such as low interest rates, lower default rates by companies and lower compensation for liquidity risk. Credit risk premia have also fallen relative to equity risk premia, possibly reflecting the activities of pension funds in purchasing fixed-income products to match their liabilities;[94]
- Liquidity in the leveraged loan market has increased as a result of the deepening of the secondary market. Lenders are increasingly able to repackage and sell on loans via collateralised loan obligation (CLO) managers and collateralised debt obligation (CDO) managers, making it possible for risk to be distributed throughout the financial system; and[95]

93 Earnings before interest, tax, depreciation and amortisation.

94 *Financial Stability Report*, Bank of England, April 2007, p 16

95 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 1.2

- Loans are increasingly being issued with fewer or less onerous covenants (i.e. covenant-lite loans), enabling borrowers to take on more debt.[96]

43. The Bank of England has noted the relationship between high corporate borrowing and private equity buyouts,[97] and reports that leveraged buy-out activity was causing public companies to increase their leverage as a defence against private equity takeovers. The Bank estimates that, following recent leveraged buyouts, the UK corporate default rate could be up to 0.8 percentage points higher on average over an economic cycle. The Bank is concerned that the increase in corporate borrowing makes companies more reliant on benign macro-economic conditions and the continued availability of cheap credit, and that developments in the sub-prime mortgage market in the US (discussed below) may provide a warning of problems ahead. Recent reports of increasing spreads on debt layers within the proposed private equity bid for Alliance Boots plc and reported tightening of credit availability suggest that debt markets are already reacting.[98]

The economic and credit cycle

44. The recent benign macroeconomic environment has been characterised by low interest rates, low inflation, strong global economic growth and a reduction in volatility. The persistence of this stability has affected financial market behaviour: the Bank of England's April 2007 Financial Stability Report discussed how the long period of stability had led to an increase in risk-taking. The Bank added that "Benign current economic conditions, the greater dispersal of credit risk and confidence that market liquidity will remain high may have weakened risk assessment standards."[99] The Bank also reported that the "search for yield" was intensifying, with credit spreads continuing to narrow, and that this had led to "investors … using more risky strategies to maintain nominal returns." [100] Increased risk-taking, coupled with an increased quantity of debt, would, all else being equal, increase the likely impact of any shock to the financial system. Highly-leveraged companies would obviously be particularly sensitive to any such shock.

45. The increase in leverage that has occurred, partly as a result of the benign macroeconomic and credit environment, increases the sensitivity of leveraged companies to macroeconomic and financial shocks. Professor Williams and others made this point in a simulation of the effect on the return to equity for UK FTSE 100 companies if they were re-leveraged from 30:70, i.e. 30 per cent debt, 70 per cent equity, to 70:30.[101] The results of his simulation show an increase in the volatility of returns to equity, with better returns during cyclical upswings and poorer returns during downturns.

96 *Financial Stability Report*, Bank of England, April 2007, p 16

97 Ibid., p 19

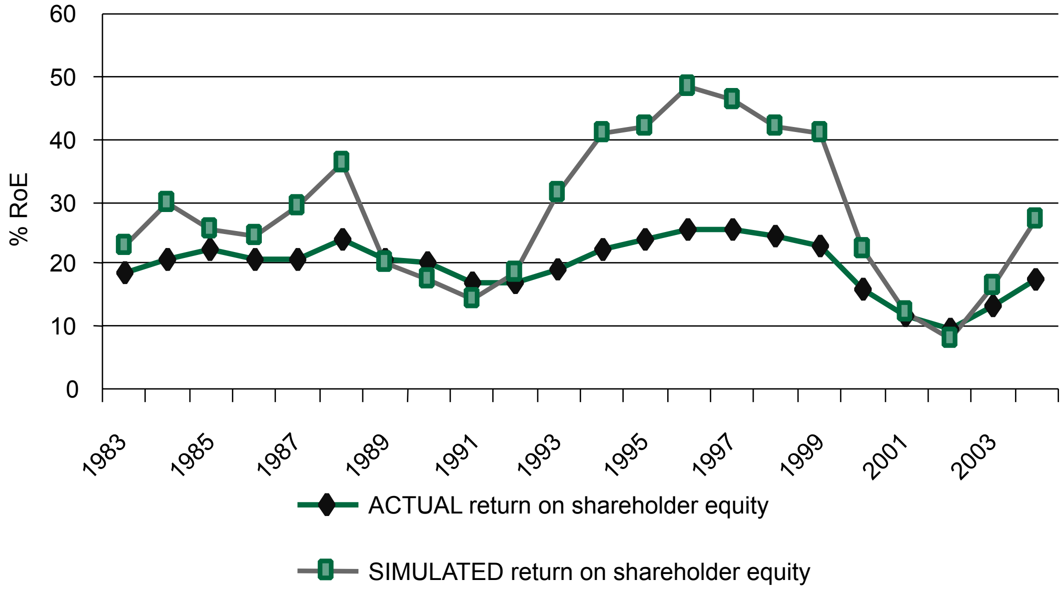
98 *Bear Stearns sends investors running for cover*, Financial Times, 21 July 2007

99 *Financial Stability Report*, Bank of England, April 2007, Box A

100 Ibid., p 17

101 Ev 116

A simulation of the effect on the return on equity (RoE) for UK FTSE 100 companies if they were re-leveraged from 30:70 to 70:30 debt: equity.



Source: Ev 116; ’[102] *calculations based on FTSE 100 company annual report and accounts.*

Note: the simulation was done by applying typical private equity leverage (i.e. 70 per cent debt) to the FTSE100, assuming a cost of debt of Bank of England base rate plus a 3.75 per cent margin.

Covenant-lite loans

46. One way in which the reduced price of risk has been expressed is through an increase in the incidence of so-called covenant-lite loans. A loan covenant is a condition that a borrower must comply with as part of the terms and conditions of the loan. Loan covenants are intended to reduce the risk to the lender of the borrower defaulting on the loan. Should a borrower breach a covenant, the lender may demand repayment of the loan in full or may agree to re-negotiate the terms of the loan.

47. There are two types of loan covenant: maintenance covenants and incurrence covenants. A maintenance covenant will typically require the borrower to meet certain financial tests on a quarterly basis. Examples of common financial tests are leverage (financial indebtedness to EBITDA), interest cover (EBITDA to either net or gross interest payments) and cash flow cover (adjusted EBITDA against total funding costs).[103] Incurrence covenants impose conditions should particular events occur, such as the issuing of new debt or payment of a dividend. The term covenant-lite applies to loans issued with few or no maintenance covenants. The emergence of covenant-lite loans is a relatively new phenomenon in Europe – there had been only three "'pure" (i.e. incurrence covenants only) covenant-lite loans issued in Europe up to March 2006.[104] The following chart shows the declining use of maintenance covenants in the US since 1999 and the sharp increase in

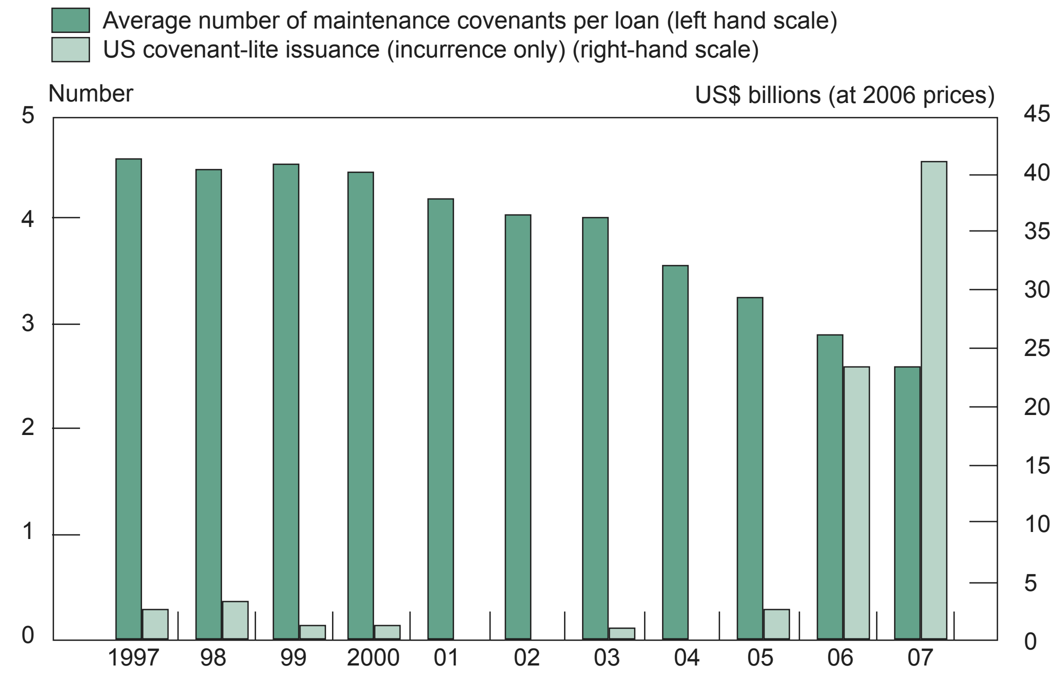
102 Julie Froud, Sukhdev Johal, Adam Leaver, Professor Karel Williams

103 Ev 211

104 Ev 211

the use of covenant-lite loans in 2006 and 2007. However, recent evidence suggests that the availability of covenant-lite loans may already be declining in the UK.[105]

Developments in US leveraged loan covenants



Bank of England quarterly review 2007Q2

48. In their November 2006 discussion paper, the FSA highlighted the fact that covenants are intended to act as early warning signals.[106] Without covenants, risks are, in effect, permitted to materialise before remedial action is taken. Although the FSA state that they will monitor covenant waivers, amendments and re-financings more closely, they admit that the very fact that the covenants are weaker means that the likelihood of credit events occurring without warning is increasing.[107]

49. Citigroup, while accepting that, in isolation, covenant-lite loans represent a loosening of credit conditions, indicates that: investors in private equity have an incentive to correct under-performance by a borrower; the borrower will need to service interest payments regardless; and there will still be detailed incurrence covenants.[108] Peter Linthwaite, then of the BVCA, stated that "By having covenant-lite loans, there is much greater flexibility on the company to restructure itself, to address any problems in its business plan, before you are at a stage where the banker, as it were, takes over the reins."[109] Robert Easton of Carlyle Group added that, "In the event of a downturn it simply means that the company will ride it out better with respect to its debt."[110] However, the Bank of England warns that, "The absence of maintenance covenants may allow companies to survive longer before

105 Axed deals reflect subprime chill, *Financial Times*, 27 June 2007

106 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 3.60

107 Ibid., para 3.117

108 Ev 212

109 Q 131

110 Q 285

defaulting but could reduce the recovery rate for investors if they do default."[111] The Bank's Governor, Mervyn King, has exhorted lenders to "be cautious about how much you lend, especially when you know rather little about the activities of the borrower."[112]

50. Deutsche Bank linked the emergence of covenant-lite loans to a more liquid market, with institutional investors, such as hedge funds, CLOs and CDOs[113] which are not necessarily accustomed to having the degree of financial control given by maintenance covenants. Citigroup[114] and Deutsche Bank[115] stated that they have internal procedures and processes which are used to make risk assessments prior to the issuance of loans. However, Nigel Jenkinson of the Bank of England questioned the quality of stress-testing conducted by banks, saying that "banks often model the effect of even severe macro--economic shocks as if they were occurring to the bank in isolation", without taking into account the effect that these shocks may have on market liquidity and the broader economy.[116]

51. **It is clear that the safeguards in place in respect of covenant-lite loans have yet to be tested. We urge the FSA and the Bank of England to continue to monitor the incidence and nature of covenant-lite loans, with a view to assessing the extent to which heavily-leveraged deals are consistent with the remits of the FSA and the Bank of England for financial and economic stability.** We note that the FSA has given greater priority to the risk posed to the wider economy by private equity than to the risk of market abuse and conflicts of interest.[117] Mr Yea of 3i Group said that he regarded excessive leverage and unclear ownership of economic risks as the most important risks, rather than ranking only as "medium high",[118] and we ask the FSA to look into this.

The US sub-prime mortgage market

52. Recent developments in the sub-prime mortgage market in the US, and the fact that the structure of that market has some similarities with the leveraged financing of private equity-backed takeovers, have increased concerns about systemic risk. The sub-prime mortgage market in the US, a relatively new phenomenon, specialises in providing mortgages to people with insufficient income, a poor credit history, high loan to value ratios or high debt burdens who are unable to qualify for a normal mortgage. As interest rates in the US have risen, more and more borrowers have got into difficulties. In March 2007, the Mortgage Bankers Association reported that 13% of sub-prime borrowers were behind on their repayments. This was followed by the collapse of two hedge funds which were heavily exposed to the sub-prime mortgage market.

111 *Financial Stability Report*, Bank of England, April 2007, p 16

112 Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 20 June 2007, p 5

113 Ev 218

114 Ev 212

115 Ev 218

116 Developing a framework for stress testing of financial stability risks, speech by Nigel Jenkinson, Executive Director, Financial Stability, Bank of England, to the ECB High Level Conference on "Simulating Financial Instability" , 12-13 July 2007, p 10

117 Para 35 above.

118 Q 273

53. The Bank of England drew out some of the similarities between the US sub-prime market and the corporate credit markets:

- Weakened credit risk assessment: Those issuing loans have reduced incentives to assess risk if they intend to sell the risk on.
- Impaired risk monitoring: The institutions to whom the risk is dispersed may have less information on the ultimate borrowers and become over-reliant on summarised risk assessments by other organisations.
- Impaired market liquidity: Financial institutions may become dependent on market liquidity to enable them to redistribute risk. Should liquidity dry up, financial institutions could be left with unplanned credit exposure.[119]

54. The key lesson is that, in a slowing market, pressure to maintain lending volumes can lead to a deterioration in credit standards. As default rates rise, markets for lending which have lax controls can quickly unravel. Therefore, it is important that lenders remain vigilant regarding the due diligence undertaken in respect of loan issuance and alert to the risks associated with weaker loan covenants.

55. Jon Moulton of Alchemy described the sub-prime mortgage market as a "very interesting prototype" for the private equity industry, with "an enormous number of parallels".[120] On the other hand, David Blitzer of Blackstone, while acknowledging similarities in the financing arrangements of the sub-prime business and the private equity industry, pointed out noteworthy differences, in particular that the "level of due diligence that is done before entering into those transactions is of a very different calibre" and that "ultimately they [sub-prime lenders] are not owners of businesses in the way that the private equity firms are owners of their businesses".[121]

Excessive leverage

56. The key issue with regard to leverage is whether market participants have overreacted to the benign macro-economic environment and easy availability of credit, causing leverage to exceed prudent levels. The FSA's discussion paper referred to the level of leverage as potentially being "excessive", and described the default of a large private equity backed company or of a cluster of smaller private equity backed companies as "inevitable".[122] Hector Sants of the FSA clarified the use of the term "excessive" as being a reference to potential rather than immediate risks, and, referring to criticisms by private equity witnesses of the use of the word, he added that "a regulator will draw attention to a potential risk maybe before that risk crystallises, while individual firms' responses will tend to be focused more on whether the risk has actually crystallised."[123]

119 *Financial Stability Report*, Bank of England, April 2007, pp 6-7

120 Q 541

121 Q 545

122 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, p 7

123 Q 505

57. The FSA put forward two schools of thought regarding the current levels of leverage in the private equity market:

- One view is that leverage levels in UK firms, particularly in public companies, are currently too low. The leveraging of companies by private equity simply makes those companies more capital efficient, enabling them to take advantage of tax relief on debt interest payments and flexible finance options.
- On the other hand, competition among banks to provide debt finance to private equity transactions may be leading them to accept weaker terms than they might otherwise prefer, and subsequently to redistribute the debt. There are strong incentives for banks to compete for the business of private equity firms, as banks can make a great deal from transaction and ancillary services and private equity firms often re-use the same banks for consecutive deals. Subsequent purchasers of the debt may be unaware of the pressures on banks to under-price risk.[124]

We recommend that the FSA examine incentive structures relating to debt.

58. The FSA adds that it is not certain which of these two schools of thought is correct, but that "the number of market participants expressing concerns over current leverage levels is high and rising."[125] Mr Sants summed up the FSA's remit on leverage by saying that "we are seeking to warn firms and the participants in the marketplace that we are seeing increasing risk in the round ... we are alerting firms to the importance of anticipating that some deals will fail in the future and make sure that they are properly positioned to manage those failures."[126]

59. Sir David Walker indicated that the structure of the debt on companies' balance sheets was also important: "leverage in private equity portfolio companies normally involves several layers below senior debt (debt that takes priority over all other debt sold by the issuer) and mezzanine debt (debt that is subordinate to senior debt), with the most subordinated debt involving few if any covenants, and thus higher risk for the lender".[127]

60. In defence of high levels of leverage, private equity firms have argued that the increased level of debt associated with a leveraged buy-out imposes a discipline on firms to focus on profit maximisation because they have to cover the interest payments.[128] Wol Kolade of the BVCA emphasised that "people have begun to understand risk a lot better and be able to price risk better".[129] The BVCA and private equity firms referred to the extensive due diligence undertaken prior to the issuance of debt both by private equity firms and by

124 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 4.14

125 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, para 4.15

126 Q 525

127 *Disclosure and Transparency in Private Equity: Consultation Document July 2007*, Sir David Walker, July 2007, p 13

128 Ev 177

129 Q 90

banks.[130] Dominic Murphy of KKR said that it was not "in the interests of any private equity firm to over-leverage companies".[131]

61. **We note that, however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk, and that this becomes more significant the more important highly-leveraged firms become in the economy. We also note that the recent increase in the number of highly-leveraged private equity-owned firms has occurred during a period of economic growth and stability, which is not guaranteed to continue. We therefore urge the Bank of England to examine the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy. We also urge the FSA to investigate the operation of due diligence in highly-leveraged firms.**

Unclear ownership of economic risk

62. The increasing complexity of the debt markets in recent years has led to greater opacity in the market for risk. Increasingly, banks that originate loans are distributing the risk to other investors, such as pension funds, insurance companies, mutual funds, hedge funds and other banks. Sally Dewar of the FSA, told us that "on day one of a deal 22% is, on average, still within any one of the original lending banks (of which there may be more than one); by day, 120 only 5% is in each of those original banks".[132] Nigel Jenkinson of the Bank of England has summed up the advantages and disadvantages of the evolution of financial markets:[133]

> Financial innovation has delivered considerable benefits. New products have improved the ability to hedge and share risks and to tailor financial products more precisely to user demand. That has enabled financial intermediaries and users of financial services to manage financial risks more effectively, and has lowered the costs of financial intermediation. And innovation and capital market integration have facilitated the wider dispersal of risks, which may have increased the resilience of the financial system to weather small to medium-sized shocks.
>
> Innovation has also delivered new challenges and vulnerabilities. Dependence on capital markets and on sustained market liquidity has increased, as banks and other intermediaries place greater reliance on their ability to 'originate and distribute' loans and other financial products, and to manage their risk positions dynamically as economic and financial conditions alter. In turn that places additional pressure on the robustness of financial market infrastructure to handle large changes in trading volumes and to cope with periods of strain. And the greater integration of capital markets means that if a major problem does arise it is more likely to spread quickly across borders. So as highlighted by a number of academics and authorities, the flip

130 Qq 133, 282, 560

131 Q 282

132 Q 532

133 Promoting Financial System Resilience in Modern Global Capital Markets – Some Issues, Speech by Nigel Jenkinson, Executive Director, Financial Markets, Bank of England, at the conference 'Law and Economics of Systemic Risk in Finance', University of St Gallen, Switzerland, 29 June 2007, p 2

side to increased resilience of the financial system to small and medium-sized shocks may be a greater vulnerability to less frequent but potentially larger financial crises.

63. The FSA's discussion paper assessed unclear ownership of economic risk as being of medium-high significance.[134] Many respondents to the paper commented on the increased diversity of debt ownership within the market, which was seen as having both positive and negative implications for systemic risk. While the reduction in individual exposure to default in a more diversified debt market was seen as a benefit, that very diversity would increase the complexity of managing a corporate restructuring or "default workout". Some respondents also pointed out that the increasing involvement of hedge funds and distressed debt funds posed additional risks. Others called for a review of the "London Approach" to such problems. The FSA in response highlighted INSOL International's "Statement of principles for a global approach to multi-creditor workouts", which updates the London Approach, while noting that "market developments may continue to challenge the ongoing suitability of this process in the future".[135]

64. Paul Tucker of the Bank of England told us that "The fact that we do not know where the risk is implies that it is not held core in the banking system and I think that is a good thing", but he added "Are we clear about the circumstances in which risk would flow back to the banking system ...?" [136] Charles Bean, Chief Economist of the Bank of England, has observed that debt providers who expect to sell on their debt may have less incentive to monitor and control underlying risks, which leads to concerns regarding the degree to which the risk is actually dispersed.[137]

65. **We strongly support the FSA's proposal to conduct "semi-annually" a survey of banks' exposures to leveraged buyouts to enable the identification of risk in a timely fashion.**[138] **We recommend that both direct and indirect exposure is surveyed. We recommend that the FSA continue to work towards obtaining assurance that the banking system has the appropriate incentive structures and monitoring mechanisms in place to handle such risk.**

66. Nigel Jenkinson of the Bank of England has said said that the Bank is "building a suite of models that allow the transmission channels for potential financial system stress to be mapped out accurately and comprehensively".[139] We welcome this development.

134 *Private equity: a discussion of risk and regulatory engagement*, DP06/6, FSA, November 2006, p 10

135 *Private equity: a discussion of risk and regulatory engagement*, FS07/3, FSA, June 2007, pp 22-23

136 HC 568-i 2006/07, Q 7

137 Charles Bean's response to Treasury Committee's questionnaire, Q 8

138 *Private equity: a discussion of risk and regulatory engagement*, FS07/3, FSA, June 2007, p 22

139 Developing a framework for stress testing of financial stability risks, Nigel Jenkinson, Executive Director, Financial Stability, Bank of England to the ECB High Level Conference on "Simulating Financial Instability", 12-13 July 2007

5 Transparency

Transparency to the public and to employees

67. Relatively little information has hitherto been publicly available about the private equity industry, and the question of transparency has become more important as the industry has grown. Sir David Walker has referred to "the understandable tendency of many in the industry … to say that 'private means private' and to be attentive to confidentiality to the point of secretiveness."[140] He told us that the industry's "significance and influence in our economy has grown hugely in the last two years" but that "its attentiveness to the stakeholder interests … has not matched that growth in its significance".[141] And Peter Linthwaite, then Chief Executive of the BVCA, accepted that "as the size of transactions has increased there is a wider stakeholder base, who may have legitimate interests in the businesses that are being acquired."[142] In February 2007, the BVCA asked Sir David Walker to undertake a review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of voluntary guidelines. Sir David told us he was focusing "almost exclusively on the buy-out end of private equity".[143]

68. In March 2007, the then Economic Secretary to the Treasury, Ed Balls MP, said of the difference in reporting requirements between private equity-owned companies and listed companies that:

> This difference is logical - it is rooted in the distinction between keeping a small group of private shareholders informed, and reporting to markets as a whole. Nevertheless, large businesses, and particularly those in the public eye, have a wider responsibility to engage with the community in which they operate and to meet the legitimate interests of stakeholders, both employees and the wider public, in how their operations affect them. As the private equity sector has grown and as some major companies have moved from transparent public to opaque private markets, this need has become more acute.[144]

69. The call for greater transparency was widely supported. For example, Jack Dromey of Unite (T&G) told us that "if one has very powerful companies operating in secret and they are totally unaccountable for the consequences of their actions for workers and the public that is wrong; it offends against what has been a generation of progress on openness and transparency of public companies".[145] The London Investment Banking Association (LIBA) described the Walker Review as "a very positive development which will likely maximise the over-all benefit [to] the [private equity] market in general".[146]

140 *Disclosure and Transparency in Private Equity: Consultation Document July 2007*, Sir David Walker, July 2007, p 3

141 Q 482

142 Q 106

143 Q 482

144 Speech by the then Economic Secretary to the Treasury, Ed Balls MP, to the London Business School, March 2007

145 Q 204

146 Ev 140

70. Trade unions were particularly concerned about the lack of transparency between private equity firms and their workforces. Paul Kenny of Unite (Amicus) told us of the difficulty, in the case of the AA, of finding out even who was involved in the takeover,[147] and the union has called for "European wide regulation on transparency and regulatory compulsion for private equity companies"[148] so that workers have the same rights regardless of the country and the company they work in. The TUC referred to the apparent contradiction between the Information and Consultation Regulations 2004, which require employers to consult employee representatives in situations such as forthcoming takeovers, and the requirements for secrecy in the Takeover Code, although the TUC recognised that this issue was not specific to private equity.[149]

71. Although ownership models are traditionally used to define the reporting requirements of companies, the TUC made the point that "economic and social impact" should be the determinant of reporting requirements, [150] rather than ownership structure, and we note that Sir David Walker proposes more extensive reporting by the larger portfolio companies. Notwithstanding the different types of equity invested in the companies, the wider issues of economic and social responsibility, especially in the cases of the larger buy-outs, are the same in terms of the role these companies play in the wider economy, as employers and as providers of goods and services to the community.

72. On 17 July, Sir David Walker proposed the following changes in reporting:[151]

- Portfolio companies that were formerly FTSE 250 companies, or where the equity consideration on acquisition exceeded £300 million, or where the company has more than 1,000 employees and an enterprise value greater than £500 million, should report to the following enhanced standard:
    - File annual report and financial statements on a company website within four rather than nine months of year-end;
    - Publish details of the board composition
    - Refer in Board statements to the company's values and its role in the wider community;
    - Cover in financial reporting the company's balance sheet management, with descriptions of the level, structure and conditionality of debt;
    - Publish a short interim statement no more than two months after mid-year.
- General partners (i.e. private equity firms) should publish an annual review, accessible on their website, containing:
    - An indication of the leadership team of the management company;

147 Q 165

148 Ev 105

149 Ev 176

150 Ev 175

151 *Disclosure and Transparency in Private Equity: Consultation Document July 2007*, Sir David Walker, July 2007, pp 7-8

- A commitment to confirm to the proposed guidelines on "a comply and explain basis";
- Details of "the philosophy of their approach to employees and the working environment in their portfolio companies", the handling of conflicts of interests, and corporate social responsibility;
- A broad indication of the performance of their funds, providing information about how value has been created;
- A categorisation of the limited partners in their funds.

73. **We welcome Sir David Walker's proposals to increase transparency in the private equity industry. We would like the guidelines published in the autumn to be clear and specific in order to facilitate compliance by the industry. In particular, we would like to see more detailed guidance on the content of:**

- **Board statements by relevant portfolio companies setting out their approach to their stakeholders, together with information on their strategy for the company;**
- **Annual reviews by general partners, including the information on how value has been created;**
- **Reports on the level, structure and conditionality of debt.**

We suggest that there be arrangements for additional independent monitoring of the industry's conformity with this code over and above the expected scrutiny by unions, politicians and the media, to provide greater assurance that compliance will not fall short of the desired level. We look forward to seeing the final details of Sir David Walker's guidelines for the private equity industry when they are published in the autumn.

Independent data

74. Another concern with regard to private equity is the general lack of independent data. Much of the data available are provided by the industry itself and some of the research is sponsored by it. Sir David Walker referred to the "partiality and unsatisfactory nature" of the data,[152] and Paul Myners described the data available as "inconsistent and/or lacking in completeness or independence".[153] Statistics which lump together all the diverse companies making up the private equity industry were particularly criticised.[154]

75. Sir David Walker's consultation document emphasises the importance of "investing resource in developing an authoritative and respected capability that avoids misleading aggregation of apples and pears and commands confidence within the industry as well as externally", and sets out the aspects on which he believes information should be

152 Q 482

153 Ev 198

154 Ev 182

provided.[155] **Given the absence of comprehensive industry-wide data on the private equity industry, we look forward to seeing Sir David Walker's more detailed proposals for developing a respected capability for providing such data that commands confidence within the industry and externally when he publishes his final guidelines for the private equity industry in the autumn.**

A legislative response?

76. Sir David Walker has said that he "does not see the need for and does not recommend any change in existing regulatory or legislative provisions on disclosure in the UK". He considers his guidelines as "particularly apt for an industry whose evolution has involved, and seems likely to continue to involve, relatively rapid change" and describes conformity with guidelines as being on a "comply or explain basis".[156] He expects that "buyout firms and portfolio companies will generally conform, with the added discipline … of external scrutiny by unions, politicians and the media". He told us that if transparency in the private equity industry was regulated from the outset, "it is an entirely predictable consequence that you will end up in a mess".[157] Paul Myners agreed with the view that this was not an area "which requires legislative intervention"[158]. However, Jack Dromey of Unite (T&G) described self-regulation by private equity as "worse than useless", and believed that "the rogues will undercut the reputable".[159] John Cridland of the CBI said that if companies did not implement a voluntary code, "it is down to you and regulatory bodies to decide whether more is necessary.[160] **We will certainly be willing to use our influence to help to ensure that any guidance drawn up by Sir David Walker is implemented.**

Transparency to investors

The purpose of transparency

77. Peter Linthwaite, then of the BVCA, told us that the main purpose of transparency was "to make sure that there is information to investors, or potential investors, from which they can make an informed decision."[161] Paul Myners observed that "Public companies work with a more complex set of requirements around disclosure in order to address the fact that they have multiple owners and their securities are freely traded. These forces for disclosure do not apply to businesses owned by private equity".[162] The CBI told us that "Private equity fund investors are far better informed about the performance of their businesses than are their counterparts in the publicly listed sector."[163]

155 *Disclosure and Transparency in Private Equity: Consultation Document July 2007*, Sir David Walker, July 2007, p 9

156 Ibid., p 4

157 Q 497

158 Ev 201

159 Q 215

160 Q 471

161 Q 106

162 Ev 201

163 Ev 156

78. The FSA has a regulatory responsibility for ensuring that there is an appropriate level of transparency to private equity investors, to enable informed decision-making and promote efficient, orderly and fair markets. The FSA told us that it had conducted a review in 2006 which had found that transparency for existing and potential investors in private equity was "extensive".[164] The FSA noted that "methodologies for disclosure, valuation and performance reporting used in the private equity market are not always applied consistently", but indicated that, because the private equity market is predominantly a wholesale market, "Investors should … have the appropriate level of sophistication to assess information given to them by funds in which they plan to invest or have invested."[165] Sir David Walker is conducting a review of around 100 private equity investors, and told us that the findings so far suggested that those limited partners were "generally very well satisfied with the flow of information, the disclosure and transparency to them". He believed that the only question remaining was "whether the methods of valuation between different funds are precisely comparable".[166] Paul Myners, on the other hand, told us that, although, theoretically, investors "should be in a position to insist on necessary disclosure standards", in his experience "investors can be quite lethargic in this respect".[167]

Competition and the fee structure

79. The fee structure for private equity is often referred to as "2 and 20", reflecting the 2% annual management fee commonly charged and the 20% rate of carried interest. Concern has centred on the fact that, despite the great increase in the size of the larger deals, the percentage charged as a management fee has fallen only moderately, apparently to 1.5 or 1.75%.[168] As Jon Moulton of Alchemy put it, "The institutions give us the same terms essentially for a £100 million fund as for a £10 billion, 100 times the fees and income. The costs of running the funds do not go up by a factor of 100. … Nobody forces the institutions to do it." Robert Easton of Carlyle Group told us that "The reason why these levels are as they are … is because the people whose money we are managing are getting good value overall and they are happy with it."[169] Dominic Murphy of KKR emphasised that the fee structure was fiercely competitive.[170]

80. On the other hand, Professor Williams linked the willingness of investors to pay high fees to the general lack of information about the private equity industry.[171] Paul Myners argued that "a more candid and complete explanation of the returns to limited partners and general partners and the construction and allocation of the general partner return might facilitate a more informed challenge to fund fees (and the level of charges to funds by general partners for other services provided to the partnership)."[172] Sir David Walker's

164 Ev 93

165 Ev 94

166 Q 492

167 Ev 201

168 Q 366

169 Q 368

170 Q 372

171 Ev 118

172 Ev 201

consultation document indicates a reluctance to disturb "the confidentiality which generally governs the relationship and information flow between general partner and limited partner".[173] **We note that the percentage fee paid by funds to general partners in the larger private equity firms has declined only to a small extent (apparently from 2% to 1.5% or 1.75%) despite the massive rise in the size of some funds. We invite Sir David Walker to consider whether more information could be made available on fees in order to make the private equity market more competitive in this respect.**

The TUPE Regulations

81. The Transfer of Undertakings (Protection of Employment) Regulations (or TUPE Regulations) are intended to protect employees if the business in which they are employed changes hands. Its effect is to move employees and any liabilities associated with them from the old employer to the new employer. When TUPE applies, employees have the legal right to transfer to the new employer on their existing terms and conditions of employment and with all their existing employment rights and liabilities intact (although there are special provisions dealing with pensions under occupational pension schemes). In order to comply with TUPE, an outgoing employer must inform and consult staff, and if there are any changes or proposals for changes following the transfer, these must be discussed with the employees' representatives. Several witnesses pointed out that TUPE applied if assets were bought from a company, but not if shares were bought, and therefore that TUPE did not apply to takeovers.[174] On the other hand, witnesses from BVCA told us that TUPE did apply to takeovers.[175] **We ask the Government to clarify the application of TUPE to takeovers in time for the resumption of our inquiry.**

173 *Disclosure and Transparency in Private Equity: Consultation Document July 2007*, Sir David Walker, July 2007, p 29

174 Qq 178, 265

175 Qq 124-8

6 Taxation

Introduction

82. The tax regime for private equity is one of the most controversial aspects of the industry. Private equity witnesses pointed out, rightly, that the tax regime for private equity is the same as for other UK companies and individuals.[176] However, the distinctive financial arrangements within the sector mean that the same tax regime can affect private equity differently from other forms of economic activity. We examine here two main aspects of this: taper relief for carried interest and the treatment of debt. Our concern here is to ensure that the tax system treats different sorts of business activities equitably, rather than conferring unfair advantages and creating distortions in the market. We recognise that any changes could have effects beyond the private equity market, and that care would be needed to ensure that such changes did not damage the UK's financial sector.

Taper relief and carried interest

83. Business assets taper relief was introduced in 1998 as part of the reforms to Capital Gains Tax (CGT). In its original form, it reduced the CGT payable on business assets that were held for at least 10 years from 40% to 10%.[177] In 2000, the period after which the maximum taper relief applied was reduced to five years, and it was reduced again in 2002 to two years. The original intention was to reward long-term investment, with a view to promoting enterprise and the venture capital industry. This was before the increase in the size of the largest private equity transactions. The questions now are whether taper relief is having the intended effect and whether it is distorting the tax treatment of company revenue.

84. In a typical private equity fund, the partners in the private equity firm invest their own money in the fund (usually 1 to 3% of the value of the fund) alongside the limited partners. We note that some partners in private equity finds borrow their share of the equity, and are therefore not investing their own capital.[178] When the fund matures, provided it has achieved its hurdle rate, the private equity partners who have invested in the fund are generally entitled to 20% of the profit above the hurdle rate. This is referred to as "carried interest" or "carry" and is subject to CGT. Because the private equity partners also work in the companies which they own, their ownership of stakes in those companies is treated as a business asset and receives the most generous form of taper relief. Such relief was originally intended to support business start-ups and venture capital which were seen as high-risk ventures, whereas it is difficult to argue that the takeover of a large established company poses an equivalent risk to the new owners. The question is, therefore, whether the reward is disproportionate to the risk, and whether the carried interest should be regarded as a capital gain or a reward for services, reflecting in the latter case the fact that it is not directly a return on the capital invested.

176 Qq 85-6; Ev 141

177 The Chancellor's 1998 Budget Speech

178 *Banks see new opening among buy-out clients*, Financial Times, 16 July 2007

85. Wol Kolade of the BVCA drew a link between taper relief and the success of the UK's private equity industry.[179] Jon Moulton of Alchemy said that taper relief was only "a small portion" of the factors affecting his tax bill, and expressed the view that "you are getting some tax and if you are not careful you might not!"[180] However, Peter Taylor of Duke Street Capital told us that he did not believe "a rate of 15 or 20% [instead of 10%] would be a material disincentive to entrepreneurs like ourselves to create value over the long term."[181]

86. Peter Orszag, Director of the Congressional Budget Office, told the US Senate's Committee on Finance on 11 July 2007 that most legal and economic analysis suggested that carried interest represented "performance-based compensation for services undertaken by the general partner". He put forward two reasons why the role of the general partner was different from the role played by the limited partners: the general partner was responsible for the day-to-day management of the fund's assets; and "carried interest is not principally based on a return to the general partner's own financial assets at risk."

87. Mr Orszag suggested three ways of reforming the tax treatment of carried interest:

- Carried interest could be viewed as an option on future profits, valued according to an option pricing model and taxed as income at the time the right to it is awarded.
- It could be viewed as a management fee and taxed as ordinary income.
- It could be treated as an interest-free loan from the limited partners. The value of the implied interest on the loan could be taxed as income as it accrued, and the remainder could be taxed as a capital gain.[182]

88. We note that partners in private equity firms typically contribute no more than 1.5% to 5% of the equity in a fund in return for the carried interest, and that there is a case to answer as to whether the carried interest is genuinely a capital gain. But we also accept that great care would be needed in making any changes to avoid damaging an important part of the UK economy. **We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their review of the taxation of employment-related securities, and that they publish the results.**

The Memorandum of Understanding

89. In 1987, the private equity industry established with the then Inland Revenue the manner in which existing law should be applied to venture capital funds structured as limited partnerships. In 2003, the Memorandum was revised to indicate that, provided private equity funds operated within certain parameters, capital gains treatment would continue to apply to profit shares earned by general partners. It provides for the general

179 Q 140

180 Qq 568, 644

181 Q 575

182 The Taxation of Carried Interest, Statement by Peter R. Orszag, Director of the Congressional Budget Office, before the Committee on Finance, United States Senate, 11 July 2007

partners to be treated as if they had paid fair value for the right to the carried interest. It also contains an override provision setting out the circumstances in which HM Revenue & Customs will not be bound by the Memorandum.[183] The Memorandum was, and is, a public document. Jon Moulton of Alchemy stated that the Memorandum had simply restored the previous situation of carried interest being regarded as capital gains, and that his firm (and some others) did not operate within the scope of the Memorandum because the Memorandum required firms to be structured in a particular way.[184]

90. **We ask HM Revenue and Customs to write to us:**

- **setting out the rationale behind the production of the Memorandum of Understanding in 1987 and the update to it in 2003;**
- **explaining the extent to which the Memorandum is used by the private equity industry;**
- **assessing whether the context in which the Memorandum is currently being used conforms with the original rationale; and**
- **stating whether the override provisions of the Memorandum have been exercised and what internal guidance on the exercise of the override has been prepared.**

It is likely that we will ask HM Revenue and Customs for oral evidence on this subject in the autumn.

Tax treatment of debt and equity

91. As with other aspects of tax, the tax regime relating to debt is the same for all companies, but affects private equity differently from other sectors because of private equity's greater use of debt. The Treasury explains that "Interest … in general is treated as a business expense for tax purposes", and "There are no plans to review this fundamental principle."[185] The GMB referred to the case of Alliance Boots, which, it suggested, would, following the takeover, offset interest payments of more £500 million against expected profits of £480 million, saving it £144 million a year in corporation tax.[186] The CBI told us that "With higher levels of borrowing by [private equity] houses, there is often an initial reduction in the tax take by government as interest is tax deductible."[187] Jon Moulton of Alchemy observed that the tax deduction for interest occurred in the UK whereas the related income might arise elsewhere.[188] Our concerns centre on the impact of highly-leveraged buy-ins on UK tax revenues, and the potential for economic distortion if the tax system significantly favours debt over equity as a form of company funding.

183 Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of managers' equity investments in venture capital and private equity backed companies, July 2003, p 1

184 Qq 568-9

185 Ev 183

186 Ev 99

187 Ev 158

188 Q 595

92. Several witnesses indicated that increased use of debt instead of equity partly reflected the removal of dividend tax credits in 1997. Professor Jenkinson said that the removal of dividend tax credits "gave a spur towards more highly-leveraged structures".[189] Chris Gibson-Smith, Chairman of the London Stock Exchange, told us that "the removal of dividend tax credit effectively taxes profits in public companies twice".[190] And Jon Moulton of Alchemy told us that "debt became more favoured in the UK when the tax credits were taken off dividends".[191] The London Stock Exchange also noted the impact of stamp duty on the cost of equity, citing a study commissioned by itself and others which had estimated that stamp duty made the cost of equity of UK listed companies between 7% and 8.5% higher than it would otherwise be.[192]

93. Any changes in the tax treatment of debt and equity would undoubtedly be complex, would affect all companies rather than just private equity firms and could easily have unintended consequences. Trade union witnesses referred to discussions by the German and Danish governments about limiting the tax deductibility of interest on debt in exchange for reductions in corporation tax.[193] The TUC suggested that the Treasury should review whether "it is in the public interest for tax relief on debt used for takeovers to be treated in the same way as tax relief for debt that will be used to invest for long-term, organic growth".[194] Paul Myners stated that "There is some evidence that some investments have involved equity masquerading as debt", and that "A number of countries have introduced some limitations on the extent to which interest may be offset against profits".[195] On the other hand, Jeremy Hand, Vice-Chairman of the BVCA, told us that "We have a tax rule already which covers the amount of interest on debt which can be deducted for the purposes of calculating corporation tax, the so-called arm's length test, which was introduced in April 2005; we believe that is competitive with other European and global jurisdictions and it would concern us if that rule were to change."[196]

94. **The Treasury is already reviewing "one specific aspect of the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals"; the outcome of this review will be reported in the 2007 Pre-Budget Report.[197] We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions.**

189 Q 7

190 Q 442

191 Q 595

192 Ev 153

193 Ev 103, 158, 179

194 Ev 179

195 Ev 202

196 Q 98

197 Ev 184

Tax domiciliary status

95. Several of our witnesses referred to the tax domiciliary status of private equity partners and private equity firms. Paul Kenny of the GMB referred to the public's "right to know that people are paying a fair share of tax, whether they are domiciled here or are offshore"[198]. The *Observer* has claimed that only 40 of the top 200 private equity partners are tax domiciled in the UK,[199] but witnesses from private equity firms regarded this figure as unrealistically low.[200] Jon Moulton of Alchemy said that he thought there were abuses by individuals of the domicile rules "which allow in the case of the UK people who have lived here 50 years in some cases still to claim they are not liable to UK capital gains tax".[201] The Treasury began a review of the tax domicile rules in April 2003.[202] **Whilst recognising that this issue is not exclusive to private equity, we ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, setting out what evidence has been assembled, whether any external advice has been commissioned and the rationale behind any proposed changes. Given the apparently rising number of the non-domiciled, and a perception that monitoring of the status of non-domiciles is weak, it is essential that the Treasury and HM Revenue and Customs are able to demonstrate that they have a rigorous approach towards claims of non-domicile status.**

198 Q 206

199 Buyout chiefs 'will escape any tax hike', *Observer*, 17 June 2007

200 Q 410

201 Q 599

202 Reviewing the residence and domicile rules as they affect the taxation of individuals: a background paper, HM Treasury, April 2003

7. Conclusions

96. The central issue remains what impact the current activities of the private equity industry, especially the larger firms, are having on the UK economy as a whole. As indicated at the start of this Report, our Report is an interim one. We recognise that many aspects of the private equity industry are highly complex and a short inquiry cannot do full justice to them. We have been correspondingly cautious in our conclusions and recommendations, preferring in most cases to highlight areas of concern or ask questions to which we can return in the autumn. Nevertheless, we believe the evidence uncovered by our inquiry has shed significant new light on an important aspect of the UK economy, and has made possible a more informed public debate than would otherwise have been the case. What is clear is that there are areas of concern which deserve continuing attention from policy-makers.

Conclusions and recommendations

Private and public equity models compared

1. **We accept that ensuring that company pension fund commitments are securely funded is a vitally important matter when major changes are made to the structure and financing of a company, especially when such changes include an increase in leverage and thus increased risk to pension funds, and we will return to this matter when we resume our inquiry into private equity.** (Paragraph 32)

2. **It is clear that there are benefits and potential problems associated both with private equity and public equity, and that different forms of ownership may be appropriate for a company at different times in its history and for different companies. We also accept that the central issue will usually be how effectively the company is being managed. There remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation. Also, we note that for some of the issues discussed in this chapter the available information, especially on the effects of management buy-ins, is patchy and these issues need further investigation.** (Paragraph 33)

3. **We invite major corporate investors to re-examine why their requirements of PLCs and of private equity-owned companies are so different, and we will take further evidence on this in the autumn.** (Paragraph 34)

Economic Risk and Financial Stability

4. **We welcome the work the FSA has carried out on the risks relating to market abuse and conflicts of interest in private equity markets, and its intention to carry out further work. We would be interested in receiving evidence on the incidence of market abuse or conflict of interest issues arising within private equity transactions or funds compared with public company transactions or investment funds. We will return to these issues as part of our work on the theme of transparency in financial markets.** (Paragraph 40)

5. **It is clear that the safeguards in place in respect of covenant-lite loans have yet to be tested. We urge the FSA and the Bank of England to continue to monitor the incidence and nature of covenant-lite loans, with a view to assessing the extent to which heavily-leveraged deals are consistent with the remits of the FSA and the Bank of England for financial and economic stability.** (Paragraph 51)

6. **We recommend that the FSA examine incentive structures relating to debt** (Paragraph 57)

7. **We note that, however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk, and that this becomes more significant the more important highly-leveraged firms become in the economy. We also note that the recent increase in the number of highly-leveraged private equity-owned**

firms has occurred during a period of economic growth and stability, which is not guaranteed to continue. We therefore urge the Bank of England to examine the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy. We also urge the FSA to investigate the operation of due diligence in highly-leveraged firms. (Paragraph 61)

8. We strongly support the FSA's proposal to conduct "semi-annually" a survey of banks' exposures to leveraged buyouts to enable the identification of risk in a timely fashion. We recommend that both direct and indirect exposure is surveyed. We recommend that the FSA continue to work towards obtaining assurance that the banking system has the appropriate incentive structures and monitoring mechanisms in place to handle such risk. (Paragraph 65)

Transparency

9. We welcome Sir David Walker's proposals to increase transparency in the private equity industry. We would like the guidelines published in the autumn to be clear and specific in order to facilitate compliance by the industry. In particular, we would like to see more detailed guidance on the content of:

- Board statements by relevant portfolio companies setting out their approach to their stakeholders, together with information on their strategy for the company;
- Annual reviews by general partners, including the information on how value has been created;
- Reports on the level, structure and conditionality of debt.

We suggest that there be arrangements for additional independent monitoring of the industry's conformity with this code over and above the expected scrutiny by unions, politicians and the media, to provide greater assurance that compliance will not fall short of the desired level. We look forward to seeing the final details of Sir David Walker's guidelines for the private equity industry when they are published in the autumn. (Paragraph73)

10. Given the absence of comprehensive industry-wide data on the private equity industry, we look forward to seeing Sir David Walker's more detailed proposals for developing a respected capability for providing such data that commands confidence within the industry and externally when he publishes his final guidelines for the private equity industry in the autumn. (Paragraph 75)

11. We will certainly be willing to use our influence to help to ensure that any guidance drawn up by Sir David Walker is implemented. (Paragraph 76)

12. We note that the percentage fee paid by funds to general partners in the larger private equity firms has declined only to a small extent (apparently from 2% to 1.5% or 1.75%) despite the massive rise in the size of some funds. We invite Sir David Walker to consider whether more information could be made available on fees in order to make the private equity market more competitive in this respect. (Paragraph 80)

13. We ask the Government to clarify the application of TUPE to takeovers in time for the resumption of our inquiry. (Paragraph 81)

Taxation

14. We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their review of the taxation of employment-related securities, and that they publish the results. (Paragraph 88)

15. We ask HM Revenue and Customs to write to us: (Paragraph 90)

- setting out the rationale behind the production of the Memorandum of Understanding in 1987 and the update to it in 2003;
- explaining the extent to which the Memorandum is used by the private equity industry;
- assessing whether the context in which the Memorandum is currently being used conforms with the original rationale; and
- stating whether the override provisions of the Memorandum have been exercised and what internal guidance on the exercise of the override has been prepared. (Paragraph 90)

16. The Treasury is already reviewing "one specific aspect of the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals"; the outcome of this review will be reported in the 2007 Pre-Budget Report. We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions. (Paragraph 94)

17. Whilst recognising that this issue is not exclusive to private equity, we ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, setting out what evidence has been assembled, whether any external advice has been commissioned and the rationale behind any proposed changes. Given the apparently rising number of the non-domiciled, and a perception that monitoring of the status of non-domiciles is weak, it is essential that the Treasury and HM Revenue and Customs are able to demonstrate that they have a rigorous approach towards claims of non-domicile status. (Paragraph 95)

Formal minutes

The following Declarations of Interest were made:

12 June 2007

Mr Michael Fallon declared the following interest, as a director and a shareholder in company whose controlling shareholder is Alchemy Partners.

Mr Brooks Newmark declared the following interest: role as an industry practitioner in private equity for 14 years and role as a member of the Private Equity Institute at LBS.

Mr Peter Viggers declared the following interest, as Chairman of a pension fund which has various investments.

24 July 2007

Mr Philip Dunne declared the following interests: a remunerated directorship (non-executive) and a registrable shareholding in Baronsmead VCT-4-PLC, a venture capital trust; a former partner in a business with a development capital arm; and Chairman and founder of a company which used venture capital.

Tuesday 23 July 2007

Members present:

John McFall, in the Chair

Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr George Mudie
Mr Siôn Simon
John Thurso
Mr Mark Todd
Peter Viggers

Private equity

Draft Report (*Private equity*), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 and 2 read and agreed to.

Paragraph 3 read, amended and agreed to.

Paragraph 4 read and agreed to.

Paragraph 5 read, amended and agreed to.

Paragraphs 6 to 11 read and agreed to.

Paragraphs 12 and 13 read, amended and agreed to.

Paragraphs 14 and 15 read and agreed to.

Paragraph 16 read, amended and agreed to.

Paragraphs 17 and 18 read and agreed to.

Paragraph 19 read, amended and agreed to.

Paragraph 20 read and agreed to.

Paragraph 21 read, amended and agreed to.

Paragraphs 22 and 23 read and agreed to.

Paragraph 24 and 25 read, amended and agreed to.

Paragraphs 26 to 32 read and agreed to.

Paragraphs 33 and 34 read, amended and agreed to.

Paragraphs 35 to 39 read and agreed to.

Paragraph 40 read, amended and agreed to.

Paragraphs 41 and 42 read and agreed to.

Paragraph 43 read, amended and agreed to.

Paragraphs 44 to 50 read and agreed to.

Paragraph 51 read, amended and agreed to.

Paragraphs 52 to 56 read and agreed to.

Paragraph 57 read, amended and agreed to.

Paragraph 58 to 60 read and agreed to.

Paragraph 61 read, amended and agreed to.

Paragraphs 62 to 64 read and agreed to.

Paragraph 65 read, amended and agreed to.

Paragraphs 66 to 70 read and agreed to.

Paragraph 71 read, amended and agreed to.

Paragraph 72 read and agreed to.

Paragraph 73 read, amended and agreed to.

Paragraph 74 read and agreed to.

Paragraph 75 read, amended and agreed to.

Paragraphs 76 to 79 read and agreed to.

Paragraph 80 read, amended and agreed to.

Paragraphs 81 and 82 read and agreed to.

Paragraphs 83 and 84 read, amended and agreed to.

Paragraphs 85 to 88 read and agreed to.

Paragraphs 89 and 90 read, amended and agreed to.

Paragraphs 91 to 93 read and agreed to.

Paragraphs 94 to 96 read, amended and agreed to.

Summary read, amended and agreed to.

Resolved, That the Report, as amended, be the Tenth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Several Memoranda were ordered to be reported to the House for printing with the Report.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

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[Adjourned to a day and time to be fixed by the Chairman.

Witnesses

List of written evidence

List of Reports from the Treasury Committee during the current Parliament

Session 2006–07

		Report
First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	The efficiency programme in the Chancellor's department	HC 483
Ninth Report	The appointment of the Chair of the Statistics Board	HC 934

Session 2005–06

		Report
First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111

Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	"Banking the unbanked": banking services, the Post Office Card Account, and financial inclusion	HC 1717