

**Sir Michael Rake's statement to the European Commission Conference on Private Equity and Hedge Funds, the National Bank of Belgium, February 26<sup>th</sup> 2009, 14.20-14.45.**

**Introductory comments**

May I firstly thank the Commission for this opportunity to speak today. It is entirely appropriate for the Commission to have an interest in the way that private equity operates and to ask questions about the manner in which it functions. There was a time when private equity was institutionally reluctant to engage with the outside world and too willing to retreat to the argument that "private means private". Private equity may indeed be private but its actions are public and have public consequences. I believe that the industry in the United Kingdom recognises the benefits of transparency and the need to engage with interested parties and shareholders.

I will make my remarks around five main areas. Firstly, the background history and original scope of the Walker regime in the UK. This explains how and why I come to be sitting in front of you today. Second, my observations on the process having completed the first report into compliance as the Chairman of the Guidelines Monitoring Group. Third, my sense of how the guidelines may evolve as we move towards the second year of this system. Fourth, and this is inevitably tentative, what the European Union might obtain from the British experience as it considers its own arrangements. Finally, some comments on the contribution that private equity might make in the current extraordinarily challenging economic environment – an adverse climate that may be with us for some time, and certainly longer than we would like.

Before that, however, can I deal with two myths about private equity in the UK. The first is that until Sir David Walker came along it was "unregulated". Private equity companies in the UK are FSA regulated. Portfolio companies are obliged to comply with company law. Indeed as I believe the EVCA submission to the Commission which outlines the existing regulatory regimes across Europe indicates, the UK has one of the most demanding regulatory frameworks in Europe. The point is that private equity has been regulated differently from publicly quoted companies, not that it has never been regulated at all. Secondly, what exists today is often described as "self-regulation". This is only partly accurate. True self-regulation involves a system when the regulators are either all industry insiders or where a majority of them are but the Chairman is not (the UK Press Complaints Commission is a perhaps notorious example here). The Guidelines Monitoring Group which I chair enjoys a majority of independent members, including my colleague Jeannie Drake, a leading British trade unionist. It could as properly be described as engaging in "independent supervision" whilst the code is voluntary. We exist to challenge this industry, not meekly to do its bidding.

So, the background history and original scope of Walker

In February 2007 Sir David Walker was asked by the British Private Equity and Venture Capital Association and a group of major private equity firms to undertake an independent review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. The request followed a period of heightened media and political interest in private equity which reflected its evolution into a mainstream asset class. In July 2007 a consultative document that set out the principles underlying the intended approach to setting guidelines was published, with the final guidelines published in November 2007.

The thresholds for compliance with the guidelines differ depending on the nature of the original acquisition by the private equity firm or firms. A portfolio company acquired in a public to private transaction is covered by the guidelines if the transaction exceeds £300 million; for a secondary or non-market transaction the transaction value threshold is £500m. In both cases, the company

must meet the additional test of generating more than 50% of its revenues in the UK and have in excess of 1,000 full-time UK employees

The guidelines require a portfolio company include as part of its audited annual report and accounts details of the private equity fund or funds that own the company and the senior executives or advisers of the private equity firm in the UK who have oversight of the company on behalf of the fund or funds; detail on the composition of the board, identifying separately executives of the company, directors who are executives or representatives of the private equity firm and directors brought in from outside to add relevant industry or other experience. Portfolio companies are also required to produce an enhanced business review ordinarily applicable only to quoted companies.

The principal recommendations of the guidelines relating to communication by private equity firms are that a private equity firm publish an annual review or provide information on its website which describes the way the FSA-authorized entity fits into the firm as a whole. The firm should give details of its investment approach including investment holding periods along with an indication of the leadership of the firm and confirmation that it has appropriate arrangements to deal with conflicts of interest. The review should include a commitment to conform to the Guidelines, provide a description of the companies in the private equity firm's portfolio and provide a categorisation of the limited partners in the fund or funds including a geographic categorisation and a breakdown by type of investor.

The guidelines also include requirements for valuation methods and reporting to limited partners private equity firms and portfolio companies should provide data to the industry association for the purpose of a attribution analysis. Firms and their portfolio companies should also ensure timely and effective communication during a period of significant strategic change. The guidelines further recommended that the BVCA establish a Guidelines Review and Monitoring Group to review conformity and to ensure that the Guidelines remain appropriate in the light of changing conditions

As I wrote in the first report of the Guidelines Monitoring Group, there has been a high level of support for, and commitment to, the Guidelines from the industry. A substantial majority of the portfolio companies reviewed have made good or acceptable disclosures with only a limited number of exceptions. Conformity by private equity firms with the guidelines was also substantial. Nevertheless, as one might expect in the first year, the nature of disclosure varies.

It should also be noted that the Guidelines require portfolio companies to adopt the requirements of the Enhanced Business Review (Section 417(5) of the Companies Act 2006) a year earlier than is required for listed companies.

The Group has written to each of the reviewed portfolio companies' private equity firm owners setting out recommendations for improvements to the disclosures in the annual report and accounts. The private equity firms have been universally positive in their responses and have either made the suggested amendments or committed to do so in the next annual accounts as appropriate.

This was the first year in a process where best practice will evolve over time. The efforts made by the private equity industry so far are therefore encouraging, but improvement in some areas is both possible and necessary.

### **Portfolio company compliance**

The review carried out for the committee by PWC assessed portfolio companies' disclosures in relation to: the additional disclosures required by the Guidelines, the pre-existing Companies Act disclosure requirements for the Business Review and the requirements of the Enhanced Business Review.

This year's review analysed a sample of 30 portfolio companies with December 2007 and March 2008 year ends. Key findings from the review of those companies were that:

- Requirements in the Guidelines to provide information about the private equity firm and the composition of the board and to include a financial review were met in almost all cases although some companies did not include all the required details on the composition of the board.
- All of the companies included a Business Review.
- Pre-existing Companies Act requirements relating to the business review, risks and uncertainties and the financial position of companies were generally well met. The business reviews and, in particular, the use of key performance indicators ('KPIs') could in some cases benefit from a greater degree of quantification and could be more integrated with the rest of the report.
- The requirements of the Enhanced Business Review are being adopted on a voluntary basis a year before listed companies are required to do so and therefore do not benefit from the example of existing best practice. Most of the companies addressed each of the requirements of the Enhanced Business Review. The reviews could benefit from a greater degree of detail and quantification and could link the narrative in the annual reviews more clearly to the financial statements.

The review also assessed the conformity of the disclosures made by the private equity firms in their annual reports or otherwise on their websites.

The Group's review found that conformity was high although some firms needed to be reminded that the requirement applied even if no portfolio companies were owned. Following the initial review, the Group contacted each firm to provide details of any exceptions to the requirements. The private equity firms welcomed this guidance and have all agreed to make the suggested amendments.

- All the firms met the requirement to detail the UK portfolio companies in the private equity firm's portfolio.
- Almost all of the firms complied with the requirement to detail the way in which the FSA-authorized entity fits into the firm of which it is a part with an indication of the firm's history and investment approach. The most common exception was not to explicitly provide any information on investment holding periods.
- All the firms provided information about the leadership of the firm and its UK presence. In some cases the UK leadership structure was not clearly presented but could be inferred from team and contact details on the website
- More than three quarters of firms initially met the requirement to provide a categorisation of the limited partners in the funds or funds. Some of the firms do not have conventional limited partner structures because they are captive private equity divisions of other organisations or are subsidiaries funded by their parent company. These organisations have agreed to provide a description of their funding arrangements. The review also found a number of firms whose initial geographical categorisation provided details of European limited partners rather than UK limited partners which did not meet the requirement. Some firms provided the analysis both by value and by number of investors.

In summary:

The industry was initially slow to appreciate the scale of its operations and thus the necessary level of transparency which this scale made appropriate. The industry has moved a significant distance in a relatively short space of time and now understands its responsibilities to a wider stake holder group. Our first report on compliance demonstrates the seriousness with which the industry has approached this exercise and its obvious commitment to furthering transparency. This is a process which will develop over time and I expect to see significant improvements as private equity firms imbed the guidelines within their broader reporting requirements.

As to recommendations of future criteria:

This is a slightly sensitive area in that discussions are continuing within the Guidelines Monitoring Group and we are not due to release our findings for another few weeks. However, it is no secret that the GMG regards its work as a process and not an event, that we will learn from our experience just as private equity firms and their portfolio companies have had to educate themselves in the first year of this new structure and that we need to balance the quantity of compliance with the likely quality of compliance. It would be a disappointment to me if the second year of the exercise did not involve a larger number of institutions than the first year has done. Nor will our initial revision of the guidelines this year necessarily be our last one. I want to ensure a credible and sensible system exists in which companies that are comparable with reasonably sizeable FTSE companies engage in a high degree of disclosure and transparency but smaller organisations do not find themselves subject to burdens which would be inappropriate for them at any time but particularly awkward in the midst of recession. The overall message which I would like to convey to the Commission, though, is that the guidelines are far likely to evolve over time although this will be a measured but firm step-by-step process.

### **Europe, in particular harmonisation/governance issues**

The Walker Guidelines have established a national system of independent oversight for the United Kingdom. Other nation states, namely Denmark, Sweden, Germany and France have also had guidelines. The details vary significantly in order to take into account the differing shape and size of the private equity markets in the respective states.

I think this is indicative of three factors which the Commission might want to keep in mind as it considers the practicality, never mind the principle, of any action or scheme it might endorse.

First, the phrase "private equity" covers a rich variety of territory much as, for example, the phrase "manufacturing industry" might do. There is no hard and fast common definition of private equity which is accepted throughout Europe which may partly explain why the regulatory regimes which exist today across member states are so extraordinarily diverse. Because the definition of private equity is an imprecise one, if what was seen as burdensome centralised regulation were introduced there would be the danger of avoidance and obfuscation as private equity firms mutated into family businesses or private companies. A one-size-fits-all approach is not the answer.

Second, although massive cross-border deals dominate the headlines, over 85 per cent of private equity is local, involving domestic investments, under the administration of national rules. Market trends, notably the disappearance of inexpensive debt for large leveraged buy-outs, mean that this proportion of "home" private equity is, if anything, likely to increase in the next few years.

Third, even if the solution adopted were a system of "Euro-Walkers" with a range of "Euro-GMGs" sitting on top of them across the European Union, it would be wise to permit those regulations and those de facto regulators considerable flexibility in how they set rules and implemented them.

Any code which attempted to impose a very rigid norm would prove counter productive in practice.

### **Attribution Analysis**

The attribution analysis commissioned by BVCA and carried out by E&Y as part of the Walker process was an important piece of research of which the industry was fully supportive. This report is based upon data drawn from those portfolio companies and exits falling within the Walker criteria, with the returns attribution drawn from the 14 highest-value private equity exits during the period 2005-2007. The report demonstrates that overall private equity adds real value. Employee numbers, productivity and assets all grew under private equity ownership. The report also showed that leverage played a significant role in the value creation process but this was not at the expense of employee numbers or pensions. There was also no evidence from the report that private equity firms 'asset-strip' companies, that is, sell the most profitable subsidiaries and parts of the business in order to make a swift return. In fact the reverse was shown to be true – private equity firms made significant additional acquisitions to complement the activities of a company following a buyout. The report also underscored the strategic and operational improvements made by the private equity owners subsequent to a buyout. This last fact is especially relevant as the 2009-2011 period is likely to see private equity companies focus even more forcefully in precisely these fields

### **Other reports**

Whilst this is a relatively small sample, the findings of this report were consistent with others which have looked at the issue of private equity ownership. Just last week the World Economic Forum published a report which re-iterated these benefits, particularly in relation to productivity; the report found that two years after companies were acquired by private equity, their productivity increased by 9 per cent. The report also showed that two-thirds of private equity's outperformance on productivity came from improvements at existing operations, and slightly more of the productivity gains were shared out in wage increases at private equity-owned companies than are at other comparable companies.

### **PE in downturn**

The economic downturn has left private equity funds as one of the few sources of liquidity left in the market. We have witnessed private equity firms stepping in to provide capital for cash-starved businesses and in some cases this injection of capital has enabled a company to continue trading. Private equity-backed companies also have the additional benefit of being able to access funds from their private equity owners to make beneficial acquisitions of companies which may be undervalued or in need of improvement. As a long-term investor, typically investing over a five to seven-year time frame, private equity funds are well-placed to invest in a downturn with a view to recovery some years hence. It is this long-term approach which in my mind sets them apart from other investment vehicles which trade in shares and esoteric instruments and do not have the connection that comes with being a company owner. It is also worth noting, especially as there has been immense discussion about bonus systems of payment and the distorting effect they might have on personal incentives, that private equity does not function in this fashion. The private equity fund model promotes an alignment of interest between private equity firms, their investors and company management which is central to its success and longevity. What must also be said, however, is that recessions do not discriminate between ownership models and many private equity-backed companies are facing a difficult 2009. It is likely that some will not survive a deep and prolonged downturn. It is also highly likely that private equity companies will come to the rescue of ailing and failing companies across the European Union which would otherwise be lost in the economic storm which they are facing. This is often in my view a better solution than the blunt instruments of administration and liquidation.

## **In conclusion**

- 1        Would not have accepted unless:
  - Support by industry
  - Committee genuinely independent
- 2        Support was there
- 3        Importance of transparency understood
- 4        Business case for PE houses = portfolio companies clear
- 5        Particularly important as holding periods will be longer with less gearing
- 6        Look forward to further working with the industry in the UK to improve and extend the transparency of the industry
- 7        Hope that there is now more light than heat in having an informed debate on these important issues.

Thank you.