



## MONEY DUE REWARDS:



**Greg Southwell**

### Private Equity – What’s it all about?

If you have been following the sharemarket or the financial press lately, you may have detected a surge of interest in “private equity”. Remember the proposed buy-out of Coles Myer of a few months ago? Or perhaps the widely reported comment by National Bank Chief Executive John Stewart that private equity is “a bubble waiting to burst”. It’s certainly current and it’s certainly news, - but what on earth is it, and is it a good investment?

Private equity funds are essentially investment funds which take on an entrepreneurial role in buying and selling businesses. Typically, they will look to buy small-medium sized businesses which have outgrown their original owners, although much larger projects (such as the Coles buyout) are now becoming more common. They generally seek out targets which look attractive in terms of both price and growth prospects.

Generally, the private equity operators will try to professionalise the management of the business (if this has not already happened), and to grow it to the next level in terms of size and competitive strength. The overall aim may be to take a business for which they might have paid, say 3-4 years of profits, and then sell it, perhaps 3-7 years later for 8-10 years’ profits.

For example, if XYZ Ltd was making \$1.5m profit each year, the private equity manager might make an offer of, perhaps \$4.5m for the business. Five years later, having made a few similar acquisitions totalling \$20m, and grown the profitability of the combined group to, say \$30m, they might then attempt to sell it in a sharemarket float for, say \$250m.

It’s potentially big money, and it’s also a bit different from run-of-the-mill stockmarket investing. This is really why private equity has lately become popular with some investment managers. There are some potential problems involved, however, and investors should also be keenly aware of these.

The first issue, is that the return on the initial investment generally takes a number of years to eventuate, often with little or no income during the intervening period. You have to be patient. In many cases, it is difficult to dispose of the investment before this occurs.

A second issue is that not all investments will prove to be as attractive as they first appeared. Growing a business is a risky and uncertain process, and there are many factors which may potentially spoil the grand plan. For this reason it is better to invest in a private equity fund with a portfolio of projects on its books, rather than one which lacks such diversification. As with hedge funds, the investor is highly dependent upon the skill of the managers in order to obtain a good result.

A third potential snare is that many such funds are highly geared, with debt levels of 70-75% of the amount invested being pretty common. This debt funding is typically provided by a consortium of banks, which is no doubt why John Stewart made his notorious comments.

In summary, I think I have to say that while private equity funds serve a genuine purpose, they are not for the faint-hearted. If you do have them, be sure to limit them to an appropriate portion of your portfolio, and make sure that the manager is subject to a professional research process, by taking appropriate professional advice.

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