

Private equity and public companies: a dialogue with Martin Halusa

Introduction

The European Audit Committee Leadership Network (EACLN) held its eighth stand-alone meeting in Amsterdam on 8 June 2007. Members discussed two topics: private equity and public companies, and the audit committee's role in major transactions.¹ For further information about the network, see *About this document* on page 8.

In a private session, members also discussed other issues with which they are currently dealing, including which board committees are best placed to oversee the risk management process and individual risks. In particular, members were interested in which committee should handle litigation risk, with some members suggesting the audit committee, and others suggesting a special social-responsibility committee, among other possibilities.

During the meeting, members participated in a dialogue with the worldwide chief executive officer of Apax Partners, Dr Martin Halusa.² The discussion covered the following topics:

- **The future of private equity**
- **Private equity's impact on large public companies**
- **Private and public company governance models**

The members of the network participating in the dialogue with Dr Halusa sit on the boards of about 20 large, mid and small cap public companies. They included:

- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Prof Guido Ferrarini, Audit Committee Member, Atlantia
- Mr Phil Hodgkinson, Audit Committee Chair, BT
- Dr DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr Daniel Lebègue, Audit Committee Chair, SCOR and Technip
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Bernd Voss, Audit Committee Chair, ABB

Other members participating in the meeting included:

- Mr Tom McGrath, Managing Partner, NEMIA Client Service and Accounts, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young

ViewPoints reflects the network's use of a modified version of the Chatham House Rule, whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations.

¹ European Audit Committee Leadership Network, *The audit committee's role in major transactions*, *ViewPoints*, 13 July 2007. Available at: www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_Jul07_View13.pdf

² A short biography for Dr Halusa can be found in the appendix on page 9.

Executive summary

Irwin Stelzer, writing in *The Sunday Times*, noted recently: “We might, just might, be entering a new phase of capitalism. Firms taken over by private-equity funds will have to improve their performance; publicly-owned firms competing with them will have to respond by improving their own profitability”.³ The network meeting enabled members to share perspectives and insights on significant issues affecting public company board members and audit committee chairs, in light of the continued rise and influence of private equity. The specific issues that network members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **The future of private equity** (*page 3*)

Dr Halusa predicted that private equity firms would globalise, as other professional services firms have before them, and that US firms would dominate the top ten private equity firms. He dismissed members’ concerns that rising interest rates could prick what might, in retrospect, be seen as a private equity bubble, saying that the main impact of rising interest rates would be to depress the prices attached to future acquisitions and spark the re-emergence of the strategic corporate buyer. Dr Halusa believes private equity will continue to grow, providing an alternative to the public capital markets. His vision is that many more public companies will go back and forth between the private and public markets as they seek a two- to three-year safe harbour in order to handle major restructuring, away from the glare of the public investment community.

- **Private equity’s impact on large public companies** (*page 4*)

Members debated why private equity firms are able to outbid public companies for strategic acquisitions, produce greater financial performance and attract superior management and board talent. Dr Halusa said that for private equity firms the best way to drive performance is to have a value-creating and market-shaping idea before an acquisition and to be relentlessly focused on a few key performance drivers. He noted that private equity firms can make the rewards for talented managers truly life-changing, without having to explain their compensation strategy to other stakeholders. He urged public company board directors to challenge senior management to improve performance and to listen to the private equity “*way of thinking about business*”, which offers alternative ideas to those available from management.

- **Private and public company governance models** (*page 6*)

Members were concerned about what several saw as a lack of a level playing field between public companies and private equity firms on transparency. Dr Halusa suggested that private equity firms would have to increase the amount of information they make public in the future. He admitted that private equity firms have done a poor job of managing their public image to date. He added that – contrary to general public perception – private equity firms do work for the benefit of a broad stakeholder set, because doing so ensures the highest possible price for the companies that they ultimately intend to sell on.

³ Irwin Stelzer, *Don’t close gates on private equity ‘barbarians’*, *The Sunday Times*, 13 May 2007. Available at: <http://business.timesonline.co.uk/tol/business/columnists/article1781451.ece?openComment=true>.

The future of private equity

According to *CFO* magazine, the rise of private equity has “filled the void created in the aftermath of the dot-com collapse and the accounting scandals”.⁴ As they have increased in power, leading private equity firms have begun to buy larger companies, raise more money and, in general, exert more influence over global capital flows. An Ernst & Young survey showed that private equity firms invested a record €47bn in Europe in 2005, 27% more than in 2004.⁵

Dr Halusa opened the discussion by describing Apax Partners as a pure-play leveraged buyout firm. He predicted that private equity firms would globalise, as other professional services firms had before them – citing consulting, advertising and auditing as examples – and that as with the other global professional services, US firms would dominate the top ten. Dr Halusa suggested that the top ten firms would between them raise 80% of private equity funds, and he noted that there were only three possible European firms likely to appear in the top ten, since firms would need to have a strong US presence to be able to compete for money, talent and deals. Since 2002, the ten largest private equity houses have raised more capital – more than \$236bn dollars – than the next 40 firms combined.⁶

Sustainability and competitive threats

Network members’ first questions concerned the sustainability of the current private equity boom and whether private equity was perhaps another financial bubble waiting to burst. In particular, members wondered what will happen when interest rates rise or liquidity dries up.

Dr Halusa said the main effect would be a decline in the prices attached to future acquisitions. There would not be much impact on current investments as prudent firms have ensured that the debt is hedged against a potential increase in interest rates. Dr Halusa continued: *“Why is private equity booming today? Because the cost of capital has lowered the cost of the deal. This can go away if the cost of debt increases. If we plug this in [to our calculations], we will pay a lower price and thus not be able to out-pay [public companies]. The real threat to private equity is the re-emergence of the corporation as a competitive threat”*.

Members were interested in why private equity firms were able to consistently outbid strategic buyers. Dr Halusa responded: *“The secret lies in EBITDA [earnings before interest, taxes, depreciation and amortisation] growth. Most corporates suffer from a lack of growth. We can show we’ve fixed [an acquired company] over three years”*. He continued: *“You have to have a strategic industry concept that is not visible to anyone else in the incumbent management ... We don’t do anything that someone else couldn’t do. My question is, why don’t they do it? What is blocking boards from acting as true fiduciaries?”*.

Some members were sceptical about whether such growth would be sustained after the private equity firm had exited from ownership, but Dr Halusa said that Apax Partners had developed an index of its former companies, showing that they *“outpaced by a huge margin”* other companies that had gone

⁴ Tim Reason, *A High-water Mark? CFO*, January 2006. Available at: http://www.cfo.com/article.cfm/5348114/c_5350503.

⁵ Ernst & Young, *How do European Private Equity Investors Create Value?*, page 1, 2007. Available at: [http://www.ey.com/global/download.nsf/Finland/Private_Equity_tutkimus/\\$file/How%20do%20Private%20Equity%20investors%20create%20value.pdf](http://www.ey.com/global/download.nsf/Finland/Private_Equity_tutkimus/$file/How%20do%20Private%20Equity%20investors%20create%20value.pdf).

⁶ PEI 50 brochure, *Private Equity International*, May 2007. Available at: http://www.six-uk.com/PEI/PEI50_Brochure_final.pdf.

public in the same industry at the same time. A comprehensive study of 496 reverse leveraged buyouts⁷ (RLBOs) between 1980 and 2002 found that their subsequent stock performances “consistently outperform other IPOs [initial public offerings], and the stock market as a whole, with economically and statistically meaningful positive returns”. The study also found “no evidence of a deterioration of returns over time”.⁸

Financial success for Apax Partners and other private equity firms comes from debt repayment and the expansion of the multiple used to value a company when it is sold on after three to five years of ownership, a number driven by EBITDA growth. Such growth in EBITDA, Dr Halusa contended, came “*not from cost cutting but from revenue growth*”. The onward sale of companies was split equally between IPOs, strategic buyers and other private equity funds.

As the threat of an economic recession does concern Dr Halusa, his firm is identifying opportunities that are independent of the economic cycle. Another threat to private equity comes from investors that have access to lower cost capital and lower return expectations, such as individuals and investment groups in the Middle East, China and Russia. Dr Halusa remarked: “*Anyone with a low cost of capital is a threat*”.

A 60:40 vision of major growth

Dr Halusa said he expected to see “*private equity growing as an alternative to the public equity markets*”. He continued: “*It is my personal belief that, in the future, companies will go back and forth. They will go private when there are large discontinuities in the value of the business from major disruptions or restructuring. Public markets punish this, so companies will have to go private to [handle the change]. We only need three to five years to do it. Once it’s done, the company will go back [to public ownership] as earnings will be more predictable*”. Dr Halusa predicted that “*the ratio of public [equity] to private [equity] will be 60:40, where now [private equity] is only 7% [when compared with total publicly traded equity]*”.

Private equity’s impact on large public companies

The impact of private equity on large public companies is becoming clearer, with predictions that \$20bn funds will become commonplace.⁹ Large-scale buyouts that might have been unthinkable in the past are now being talked about regularly. While not every company has direct experience of private equity, public companies can be highly influenced by private equity transactions that occur within their sectors and countries.

The performance gap

While studies have come to different conclusions about the alleged performance gap between private equity-owned and public companies, recent data shows that leveraged buyouts delivered 22.2% returns

⁷ The term reverse leveraged buyout refers to former portfolio companies owned by a private equity fund that are sold through an initial public offering in the public capital markets.

⁸ Josh Lerner and Jerry Cao, *The Performance of Reverse Leveraged Buyouts*, October 1 2006. Available at: https://wpweb2.tepper.cmu.edu/wfa/wfsecure/upload/2006_1.804574E+07_RLBOPerformance_10152006_new_NO_NAMES.pdf.

⁹ Apax Partners with the Economist Intelligence Unit, *Unlocking global value: future trends in private equity investment worldwide*, page 4, 2006. Available at: http://www.apax.com/Unlocking_global_value_-_Future_trends_in_private_equity_investment_worldwide.pdf.

for their owners in 2005, while public companies delivered 14.1% returns over the same period.¹⁰ Furthermore, European companies bought in leveraged buyouts continued to outperform public companies over 20 years by more than 6% annually.¹¹

Dr Halusa said that *“the average return on equity of 8% is [poor]. Only the top-quartile firms outperformed the market year in and year out”*. Research by McKinsey & Company shows that *“three-quarters of private equity firms perform no better than the stock market over time. Even so, the top 25% of private equity firms do outperform the relevant stock market indexes. Moreover, they do so by a considerable margin – and persistently”*.¹²

Dr Halusa said that in order to improve success, private equity firms need to make selective investments and then manage the management teams effectively. This echoes the findings of an Ernst & Young report on the 100 largest exits by private equity investors in Western Europe, which showed that the average enterprise value of those owned by private equity investors doubled to €900m at exit, after an average ownership of three-and-a-half years. Secrets of success included careful and selective buying, driving delivery of the business plan, working with the right management team, and selling well.¹³

Apax Partners approaches the task of improving enterprise value by putting a team of people to work examining the industry and individual companies for up to a year before making any approaches. *“We spend an enormous amount of time looking at companies and coming up with a plan. We use three measures: EBITDA growth, cash generation and possible multiple expansion. We need to get growth”*.

Members wondered whether private equity had any interest in long-term value creation. Dr Halusa said: *“The best way to create value is to have an idea when you go into a business and be focused on a few drivers. Normally we get that done in two to three years, then we move on as the idea is exhausted. We would have to get lucky to have another idea [as good as the first one]. We have to leave some growth and money on the table so the buyer can make a return”*.

Competing for talent

Malcolm Salter, professor emeritus at Harvard Business School, asserts that the boards of private equity-sponsored buyouts are “more informed, more hands-on, and more interventionist than public company boards”,¹⁴ utilising a variety of innovative governance tactics, such as well-designed incentives and constant information flows that are not built around quarterly reporting. Dr Salter notes three private equity board practices that public boards should consider adopting: expanding the director pool to include more former executives and entrepreneurs, increasing director compensation, and ensuring directors have a significant amount of their personal wealth at risk, the value of which depends on the success of the company.¹⁵

¹⁰ David Rubenstein, *The Similarities and Differences between the Tech Bubble Burst of 2000 and the Current Private Equity Markets: Are we on the verge of a PE bubble burst?*, presentation slide 26, 28 February 2007. Available at: <http://www.slideshare.net/danprimack/super-return-final>.

¹¹ Ibid.

¹² Andreas Beroutsos, Andrew Freeman and Conor F. Kehoe, *What public companies can learn from private equity*, McKinsey on Finance, page 1, no. 22, Winter 2007. Available at: http://corporatefinance.mckinsey.com/_downloads/knowledge/mckinsey_on_finance/MoF_Issue_22.pdf.

¹³ Ernst & Young, *How do European Private Equity Investors create value?*, pages 2–3, 2007.

¹⁴ Malcolm Salter, *Learning from Private Equity Boards*, Harvard Business School Working Knowledge, 17 January 2007. Available at: <http://hbswk.hbs.edu/item/5586.html>.

¹⁵ Ibid.

Members were intrigued by private equity's ability to attract senior management and board talent. One private equity commentator observed that private equity firms "can raid companies that are legendary executive-training academies, using mammoth pay packages to lure away their most valuable assets in today's economy: their best managers".¹⁶ Given that fact, is it harder now for public companies to attract high-quality management and directors?

Dr Halusa commented: *"Private equity is very lucrative. Seventeen years ago, no one would talk to us. Now, we can get almost any manager in the world to come and talk, no matter how high-level they are ... We look at candidates who are highly quantitative managers, who focus on KPIs [key performance indicators] and delivery. The numbers in the plan speak to them. We don't want 'people managers' or 'anecdote managers'. We want people who are very money orientated. We offer them a life-changing amount of money if they do well"*.

Advice for public company directors

Given that private equity can seemingly outbid public companies for strategic acquisitions, produce greater performance and attract superior talent, one audit chair asked what advice Dr Halusa would give to public board members, saying: *"Should we just jump out [of] the window?"* Dr Halusa, in fact, had two other suggestions:

- **Partner with private equity.** *"For example, we were called by a major market player; they asked us to team up to make an acquisition. Our investing with them was a huge vote of confidence for management's plan and helped lock in the share price. We would sit on the board of the acquired company to ensure independent value creation ... They are using us as a catalyst for their own goals"*.
- **Challenge management teams to improve performance.** Boards should challenge management teams to come up with a business plan that makes the business an unattractive purchase for private equity – by ensuring that there is no additional value to create. Dr Halusa said: *"We spend a huge amount of time focusing on establishing a specific business plan with management, developing the plan, talking about the plan and activating the plan. Once we have a plan, we do weekly updates and monthly meetings. The key difference [between private equity and public companies] is that we always look back to the original plan – not only annual budgets – and how we are positioned to make sure that we are able to fulfil the original plan [regardless of other circumstances]"*.

Dr Halusa added: *"If a CEO or board calls me to look at the business and say what we'd do if we were running the company, the chances are they might end up selling the whole or part of the company. Listening to the PE way of thinking about business may give you ideas you can't get from your management team"*.

Private and public company governance models

Companies owned by private equity firms face fewer regulatory constraints on their governance structures than their publicly-owned counterparts, and that relative freedom makes possible greater

¹⁶ Geoffrey Colvin and Ram Charan, *Private equity, private lives*, *Fortune*, 27 November 2006. Available at: http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm.

alignment of the interests of a limited number of key stakeholders, such as the companies' own investors and management.

The reported returns to shareholders that private equity firms are achieving prompted members to discuss differences in public and private company governance with Dr Halusa. One member argued that, given the long-term vision that Dr Halusa had set out for public and private markets, *“we need the ultimate investors to have more oversight of this part of their portfolios. They will want more transparency”*. In Dr Halusa's opinion, there were two levels of transparency in private equity:

- **Transparency to investors.** This, he said, *“is extraordinarily high. There is detailed quarterly reporting”*. The typical investor also uses specialist third-party consultants to consolidate data across as many as 50 different private equity firm relationships and about 100 funds.
- **Transparency to other stakeholders.** Here, Dr Halusa commented: *“There is a whole other world, including the press and government, where there is no transparency at all. We don't communicate to them. The negativity in the press is because all of a sudden a company that is understood and known goes private and they get zero information”*. However, Dr Halusa suggested: *“As an industry, we will start producing more public information”*.

Governance arbitrage

Members were concerned with what several saw as a lack of a level playing field between public companies and private equity on transparency. Dr Halusa admitted that not only was there not a level playing field, but that private equity firms will also exploit the opportunity for governance arbitrage: *“Governance hampers public companies in many ways. One way is that public company directors are vastly underpaid, considering the amount of risk they take. Directors often can't say no to our deals offering a 30% premium and risk getting sued, [or] take the risk [of trying] to produce that income on their own”*.

Members also wanted to know if there was a role for non-executive directors and audit committees in companies owned by private equity:

- **Non-executive directors.** Dr Halusa said: *“The most important relationship is a personal relationship between the deal partner and the CEO. It is a very intense relationship. There is a daily phone call or two. It is also a supportive relationship – someone the CEO can talk to who has skin in the game ... We do have non-executive directors on all boards in case that relationship breaks down and you need someone who can help. Most of us are inexperienced managers who have never run businesses before. We are usually much younger than the CEO. [Non-executive directors] help us to not make mistakes and to listen carefully”*.
- **Audit committees.** One member asked: *“Do you keep audit committees [in place] for sell-on purposes?”* Dr Halusa replied: *“We are not well developed on this, but [the] bigger businesses [we are now buying] need an audit committee more. We need to be at the leading edge of corporate governance behaviour going forward. Today [the private equity firm acts as] the audit committee”*.

Responsibility to stakeholders

Public companies must address various stakeholder constituencies, including shareholders, management, labour and regulators. However, private equity firms often own most, if not all, their acquisitions.

They are the sole shareholder, answerable to their limited partners for the success of the businesses they acquire. Members wanted to know whether private equity firms need to take a wider stakeholder set into account.

Dr Halusa revealed that Apax Partners is developing a governance policy: *“We want to behave [in a certain] way and show the outside world that we have [a policy]. It is not ruthless Anglo-Saxon capitalism that cares only for shareholders. We only make money by selling businesses for more than we paid for them ... If management and labour are at war, it will impact the price. If R&D is cut to the bone, that will come out in the due diligence. R&D increases, not decreases, [in private equity-owned businesses] because it adds to value. So we do take care of wider stakeholders”*. However, Dr Halusa freely admitted that PE firms have a poor reputation: *“We were all unprepared, inexperienced and incompetent in the area of communicating to the general public”*.

Conclusion

Public companies have to confront private equity firms every day, whether competing for a strategic acquisition, buying a company from the firm or trying to hire talented managers. Now those firms have laid down a new challenge aimed at board directors themselves. In the words of the Apax Partners CEO: *“What is blocking boards from acting as true fiduciaries?”* Dr Halusa wants to see board directors challenging senior management to improve company performance, and he suggests that boards seek out fresh ideas and new partnership opportunities with private equity firms. Dr Halusa’s vision of companies that regularly cross the border between the public and private markets is a compelling one. The question remains, will companies be smuggled over the border by private equity firms or will they proactively seek to partner with those very same firms?

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of Dr Martin Halusa and the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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Appendix: Short biography of Dr Martin Halusa

Martin Halusa is worldwide chief executive officer of Apax Partners. His investment experience has been primarily in the telecommunications and service industries.

Dr Halusa began his career at The Boston Consulting Group (BCG) in Germany and left as a partner and vice president of BCG worldwide in 1986. He then joined Daniel Swarovski Corporation, Austria's largest private industrial company, first as president of Swarovski Inc. (USA) and later as a director of Swarovski International Holding in Zurich. In 1990, he co-founded Apax Partners in Germany as managing director.

Dr Halusa graduated from Georgetown University, received his Master of Business Administration from Harvard Business School and his PhD in economics from Leopold-Franzens University in Innsbruck.