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FUND MANAGER AND UNDER THE RADAR REPORT COLUMNIST ANDREW BROWN LIFTS THE LID ON SOME OF THE TACTICS USED BY PRIVATE EQUITY FUNDS TO SELL ASSETS INTO THE PUBLIC MARKET. IT IS A MUST READ FOR ANYONE INVESTING IN A COMPANY WHICH CAME FROM A PRIVATE EQUITY VENDOR.

ANDREW BROWN COMPANIES TRUST

Part I: How to make a billion dollars and not tell anybody

THE SECRET PRIVATE EQUITY DOESN'T WANT YOU TO KNOW

Individuals have been purchasing shares in companies floated on the exchange by private equity for many years, and there is nothing wrong with this. What is wrong is where investors don't know what private equity is making out of the transaction.

Specifically, anyone looking at purchasing an initial public offering (IPO) where the vendor is private equity needs to know what PE paid; what it did to the asset; and what it's selling it you for.

These prospectuses are often 230 pages long. You read page after page about the future outlook and corporate governance, but it doesn't contain the most basis of information, which any purchaser of a house takes for granted. The department store group Myer listed on the ASX four years ago at $4.10 ascribing an equity market value back then of close to $2.4 billion. Even now, no one knows how much the private equity vendors including TPG, Blum Capital and the Myer family itself made from this deal.

The consequences of not knowing this is that an investor is left in the dark about an asset and its potential to generate an adequate return.

Below in a Special Report for Under the Radar Report fund manager Andrew Brown lifts the lid on the murky world of private equity and its super profits, which are often achieved at the expense of the people who they're selling to – you and me.

Next week, Andrew goes through each of the big private equity transactions to find out just how much private equity have made and why. But more importantly, what's left for investors that they've sold to, in the newly listed entities.

As Andrew will say in Part 2, next week, the fact that Myer's EBITDA is likely to be down to around the $250m to $260m mark in FY14 against the prospectus estimate of $330m shows you how dry the retailer's lemon was squeezed. Buying a lemon is bad enough; buying a dry lemon from a bunch of overseas bankers – who escaped tax free - is rather worse.

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WHEN THIS LACK OF DISCLOSURE STARTED

28 September 2009 was a seminal day in the private equity industry in Australia. It was the lodgement day for the Myer Holdings prospectus, replete with Jen Hawkins and serious amounts of forward looking strategy, information and commentary on how the management team had turned the business around after its acquisition from Coles-Myer in June 2006. What was missing was one essential piece of information: what return were the private equity sellers making? Why so seminal? Not because the float was hopelessly overpriced and overhyped, but because it set the precedent for every private equity offload onto the ASX to remain devoid of this information. Quite staggeringly, ASIC seems to see no need for its requirement either, despite the inherent suspicion between private and listed equity investors.

WOULD YOU ACCEPT THIS IF YOU WERE BUYING A PROPERTY?

If I bought a unit two years ago for $600,000, and now have it on the market for $1,000,000 there are various historical things you would want to know. For example, have I just held it and done nothing, or spent significant amounts on renovation? Have I leased out the spare bedroom? Has there been very little past spend on the block which I now have to fund? And much more.

It's not just all about the suburb being hooked up to the new six lane expressway to the city and having a new school, a train station and a Woolies.

The issue is not, "How much profit have you made because I'm a tiny bit jealous?" Far from it, as a prospective buyer, you want to know: "What have you done to earn the return you're asking for?"

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In some cases, the answer is "sell assets and hope you don't notice"; while in others, a seemingly large return is justifiably earned by cutting costs and/or boosting sales, thus putting the business on a higher earnings plateau than it was prior to the purchase.

WHY IT'S UNDER THE RADAR

You may not think that high profile private equity sales turned new listings such as Myer (MYR), Dick Smith (DSH), Healthscope (HSO) and Spotless (SPO) are exactly "Under the Radar". What is "Under the Radar" is the outrageous returns and repricing of some of these floats resold to the market. We are talking multiples ranging between 10 and 23 times the incremental EBITDA, meaning the earnings before interest, tax, depreciation and amortisation (EBITDA) generated by the private equity owners during their tenure.

When the private equity groups Carlyle and TPG purchased the hospital owner/operator Healthscope in October 2010, the business was earning $278m of EBITDA. When they sold it to the market in July 2014, the business was earning $357m of EBITDA. Private equity improved EBITDA by $79m a year. But investors in the re-floated company were asked to pay an extra $1,859m of enterprise value (debt plus equity) to own Healthscope. This amounted to $23.53 for every dollar of improved profitability, or "incremental EBITDA".

What is amazing is that none of the above is in the prospectus. ■

NEXT WEEK PART II: Andrew goes through each of the big private equity transactions to discuss the detail behind each of these deals and the takeouts for investors in IPOs.

Below are estimates at what four of the higher profile floats made for their sellers and how. Remember, the point here is that it's only an estimate and is caveat emptor because of the lousy disclosure on the sales.

PRIVATE EQUITY IPO PROFITS

	DSH	HSO	MYR	SPO
Date acquired	Nov-12	Oct-10	Jun-06	Jul-12
Date resold	Nov-13	Jul-14	Sep-09	May-14
Acquisition EV ($m)	94	2,644	1,410	999
Capital and dividend stripped by PE ($m)	24	-	560	450
sale EV ($m)	534	4,503	2,776	2,375
Uplift ($m)	464	1,859	1,926	1,826
EV/EBITDA at purchase (x)	2.8	9.5	9.7	7.1
EV/EBITDA at sale (x)	7.4	12.6	8.4	9.4
EBITDA at purchase ($m)	33	278	145	140
EBITDA at sale ($m)	72	357	330	253
Price per $1 of incremental EBITDA	$11.90	$23.53	$10.41	$16.16
Estimated profit to owners ($m)	391	1,318	955	873
Return	**558%**	**88%**	**223%**	**125%**

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He goes through each of the big private equity transactions to find out just how much private equity have made and why. But more importantly, what's left for investors that they've sold to, in the newly listed entities.

After this, Andrew delivers some important take-outs for you to read so that you are prepared the next time you're offered some stock from a Private Equity originated IPO.

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A MORE RECENT LISTING: HEALTHSCOPE

Another example helps explain the table below. When the private equity groups Carlyle and TPG purchased the hospital owner/operator Healthscope in October 2010, the business was earning $278m of EBITDA. When they sold it to the market in July 2014, the business was earning $357m of EBITDA. Private equity improved EBITDA by $79 a year. But investors in the re-floated company were asked to pay an extra $1,859m of enterprise value (debt plus equity) to own Healthscope. This amounted to $23.53 for every dollar of improved profitability, or "incremental EBITDA".

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Myer (MYR)

Private equity groups TPG and Blum and the Myer Family and management acquired Myer in June 2006 for $1.41bn – financed with $428m of equity (subsequently a further $20m was added) and $982m of debt. We call the addition of these two "enterprise value" (EV). By 24 August 2007 – fourteen months later, these parties had extracted a $364m capital return and $196m dividend, largely funded by the sale of the Melbourne store. Hence, all of the equity plus $112million had been returned within 14 months.

During its period of ownership under private equity, Myers management grew EBITDA from $145m to $330m. The business was sold to investors in an IPO, being floated on the ASX with a value of $2,384m in November 2009.

Dick Smith (DSH)

Australian based private equity group Anchorage Capital Partners and management acquired Dick Smith for $20m plus deferred payments from Woolworths in November 2012. The deferred payments met by the group were $50m, of which $24m was paid from the float. The acquisition price was $70m in total.

DSH was refloated with an EV of $534m and all of the float proceeds effectively went to Anchorage. The private equity group also retained shares in the company. This is the best deal of the lot – done and dusted in just over a year and taking advantage of a very poor seller.

Healthscope (HSO)

The original listed company was purchased by Carlyle and TPG in October 2012. The EV paid was $2,644m, of which equity represented $1,924m and debt was $720m. Like an enormous soufflé, this expanded out to a figure of $4,503m on an IPO flotation in July 2014. Massive amounts of debt were added to the business, which was extensively regeared – as can be seen in the prospectuses for the issues of Healthscope Notes I and II – and was an effective leveraged buyout. EBITDA growth has been modest – at about 7.7 per cent a year from acquisition – but you are paying mightily for it. The private equity sellers are receiving a capital uplift of over $23.50 for every incremental dollar of pre-tax pre-interest profit the generated in the business. Not with my money.

Spotless (SPO)

Spotless was acquired by Pacific Equity Partners in August 2012 for an EV of just on $1bn. Page 93 of the prospectus tells us that PEP returned capital to itself of $301m giving itself a dividend of $148.5m in the half year to December 2013. As the vendor in the float, PEP took $366m of the cash proceeds directly and through a market stabilisation exercise. Adding this to the dividend and return of capital, it gave the private equity group a total return of $816m, which compares to the cost of buying the equity in mid-2012 of about $707m. This is $109m in cash profits to the owners. On top of this, PEP still holds 475m shares, or 43 per cent of the total listed capital. At the float price of $1.60 a share, this represents another $760m.

RADAR TAKE-OUTS

If this hasn't convinced you to be very wary of re-cycled private equity transactions, then at least study these four key lessons when buying a float – big or small from private equity:

1. Lobby ASIC to make these people disclose this stuff – I've had to ferret around to find it and you can hardly expect the selling investment bank to tell you.
2. PE floats are not all bad – some top performers and great businesses like Veda and Invocare have come from private equity stables; but you must look at what these guys have taken out in return versus what they have added in profit, capex and longer term repositioning. Of this group, at the float price, Spotless looked the best.

   Because of the slower growth in EBITDA from Healthscope, it may have the best longer term opportunity; however, the float pricing was so farcical that it's not worth pursuing.
3. I urge you (or your kids) to study the Myer deal – I reckon it's the classic management buyout/private equity transaction in Australia – getting $1bn of debt financing pre-GFC; raising cash quickly through selling inventory; selling a strong property asset at the right time; orchestrating a classic cost out; and then using a window in the equitymarket – and some extraordinary hype – to sell. The return of 223 per cent understates the reality because the money was returned to the buyers so quickly. On an internal rate of return basis, it's exceptional, delivering an annualised return of about 94 per cent, on my numbers. ■