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Reining in the biggest game in town

When New York-based private equity firm Blackstone Group netted its co-founders more than US$2.4 billion in its initial public offering in June and then in early July Kohlberg Kravis Roberts & Co (KKR) filed a planned US$1.25 billion listing, private equity (PE) suddenly began attracting unwanted attention. While KKR has been hit by the subprime mortgage crisis, politicians have been homing in on the mega-profits being made by these investment firms which raise money from private sources rather than by using the stock market.

"I think both in the UK and the US, there will be some tax legislation proposed which is designed to increase the taxes on PE activity," says **Joe Rice**, one of the founders of Clayton, Dubilier and Rice (CD&R), which manages equity capital in excess of US$10 billion.

At the centre of the tax issue is the gentler treatment of capital gains rather than income. The Economist points out that people in private equity firms receive a large part of their pay as "carried interest" – usually 20 per cent of investment gains.

Carried interest is treated as a capital gain on investment rather than as income – this means a 15 per cent capital-gains rate in the US rather than the 35 per cent corporate tax rate, while in the UK the effective tax rate can be as low as 10 per cent compared with the usual 40 per cent on gains and income.

The original intention of this tax treatment had been to reward entrepreneurs for the hard work they have to put in to build up their businesses. Reformers now argue that PE partnerships do not even invest much of their own money and should therefore be taxed at regular income rates.

'A very easy political target'

As to whether the ire of legislators is justified or not, Rice says "it's simply a fact." He adds that "it depends on where the votes are, quite frankly."

"Private equity is a very easy political target … If Congress and Parliament decide that it is in their political interest to have some legislation which disadvantages the existing private equity industry, it's going to happen. And with the [US] election season upon us, it's hard to think that they won't take a run at it."

Along with a reversal of the conducive tax environment, Rice also sees the economic cycle nears its peak, which he expects will adversely impact future deals. "The deal business is in many respects a function of the stock market. The stock market has historically gone down when economic activity has gone down. And so if you get a significant decline in the stock market, you will undoubtedly cut into the amount of deals that are getting done and the prices at which they're getting done."

Nonetheless, Rice says it will still be business as usual at CD&R, as he does not think "the legislation that has been proposed will have an impact on the business qua business." CD&R will continue to look for low-risk investments, he says, characterized by companies with multiple suppliers, multiple customers, no dominant competitor in their industry and relatively low capital investment requirements.

Furthermore, as these investments tend to come from divestitures by larger companies, CD&R will be seeking operational control by having the ability to replace underperforming management. Even when the large ticket size of the deal requires CD&R has to join forces with other PE firms, Rice says CD&R will try to ensure it can appoint the chairman of the board and also have the right to replace the target firm's chief executive officer.

Mulling an Asia move

CD&R has offices in New York and London, but currently has no footprint in Asia. Rice says his company "didn't have an appreciation for a long time of the size of the market that Asia was becoming." Turning its attention now to the region, CD&R feels that many other players "have been out here for a while who have established their positions … and soaked up most of the available talent."

Even Japan, whose market characterizes the kind of control investing that CD&R does, seems "a market in which every PE firm of any size from US, Europe or Asia, already has an office … in which experienced PE people are in great demand and therefore in very short supply".

"All of which says to me that coming out and indiscriminately putting an office somewhere, just so we can say we have an office out in Asia is not a smart thing to do."

Rice recently took part in a roundtable on alternative investments at INSEAD's Asia Campus in Singapore.

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