House of Commons

Business and Trade Committee

Oral evidence: Private equity and the retail sector, HC 416

Tuesday 19 December 2023

Ordered by the House of Commons to be published on 19 December 2023.

Watch the meeting

Members present: Liam Byrne (Chair); Liam Byrne; Jonathan Gullis; Ian Lavery; Andy McDonald; Charlotte Nichols; Mark Pawsey.

Questions 1-49

Witnesses

I: Nadine Houghton, National Officer, GMB Union, George Lagarias, Chief Economist, Mazars Wealth Management, John Plender, Senior Editorial Columnist, Financial Times and Eli Talmor, Emeritus Professor of Accounting, London Business School.

Examination of witnesses

Witnesses: Nadine Houghton, George Lagarias, John Plender, and Eli Talmor.

Chair: Welcome to this morning's sitting of the Business and Trade Committee, in which we are looking at the role of private equity and the UK retail structure. We are kicking off with an expert panel; thank you very much indeed to our witnesses for joining us. Could you just say a word of introduction for the record? Professor Talmor, do you want to start, then we will go down the line?

Eli Talmor: Sure. I am Eli Talmor, a professor at London Business School. I set up the private equity practice at London Business School—academically only, but I was quite engaged—and that really became the hub for education on private equity, with textbooks and such.

Nadine Houghton: I am Nadine Houghton, GMB national officer. We recognise Asda workers in both retail and distribution.

George Lagarias: I am George Lagarias, chief economist at Mazars wealth management.

John Plender: I am John Plender. I write for the *Financial Times*. Among other things, I am a chartered accountant, and I am a trustee of a pension fund that manages £3 billion-worth of assets.

Q1 **Chair:** Perfect. Thank you so much. Professor Talmor, I will start with you. Can you briefly tell us why private equity investment is now so important to the UK high street?

Eli Talmor: Well, from a broad perspective, private equity as an asset class has grown phenomenally over the last two decades—from being on the fringes of alternatives to the centre stage of capital markets.

Before I answer about the UK specifically, I would say that, in a global sense, it has become about 30% of private capital allocation. The statistic we have is about US pensions, but that is because they have been around the most and that is where we have the data. So that is 30% in alternatives; 20% of that is in private equity allocation—so the pensions of employees—and 10% is in real estate and other real assets such as energy.

Private equity has a unique structure. The investment is made out of a fund structure to which the institutional investors—particularly the pensions, insurance companies and such—invest in advance. So the fund structures have the money in advance and then deploy it according to the opportunities that they see over the five years.

That was tremendously helpful in the global financial crisis because, when the world came to a halt and we saw so many bankruptcies—all the way from the nationalisation of the Royal Bank of Scotland, Lloyds bank acquiring HBOS, Lehman Brothers and so on—the only sources of funds at that time were private equity, who raised the money in advance, and sovereign wealth funds. I remember that very vividly.

Private equity is divided into two groups. One is the so-called buyout of existing bigger companies and the other is venture capital. Venture capital is a huge driver on the economy because of the role of technology, but you need to combine technology with financial resources, hence the ability of venture capital to fund those innovations, which definitely boosts the particular countries that are strong in that.

Q2 **Chair:** Do you have a sense of how much private equity investment is now coming into UK retail?

Eli Talmor: I would say that retail as a whole has had its ups and downs. I would not say that retail is typically for private equity because private equity is very expensive funding that is really transitional capital. In other words, it is for a situation in which you have a change—either technological or through bankruptcies or any other type of distress. A company that is doing business as usual—Coca-Cola, for example—is not for private equity. It is about engaged ownership; you have to be there alongside management and be involved day in and day out.

Q3 **Chair:** And so how does private equity change the kind of DNA of corporate governance in the UK?

Eli Talmor: It is exactly the fact that it is a fixed time horizon that brings a reality check. It is engaged ownership and institutional money that is invested to unlock value, but it has to be with the view of an exit. That exit actually is doing a few things. First, it is very timely to make the impact on the economy fast. Secondly, it brings reputation. In other words, if something bad happens to an investment, that particular fund cannot raise money any more.

Q4 **Mark Pawsey:** I just want to understand a little more about the role of private equity. Mr Lagarias, you have written that private equity is based on a concept of cheap financing. We all know that probably in the past 15 years interest rates have been very low, but we are now in an era of rather higher interest rates. What is the impact of higher interest rates on the model that Professor Talmor has been telling us about?

George Lagarias: Professor Talmor was right when he said that private equity has grown exponentially in the past few years; as you very well put it, that has happened because of cheap financing.

Q5 **Mark Pawsey:** In the absence of low interest rates, would the surge that we have seen in private equity financing not have happened, in your view?

George Lagarias: It doesn't happen immediately, and you don't see the breakdown in a sector immediately. In fact, that can sometimes convey a false sense of security. Cause and effect are not immediate for someone to see. That is usually the root cause of many crises; we tend to disregard it and ignore it because it didn't happen immediately as predicted.

Q6 **Mark Pawsey:** Mr Plender, do you share that view—that private equity has mushroomed because of low finance costs? What happens now that we are moving into an era of higher finance costs?

John Plender: I think cheap finance is substantially what has driven the extraordinary growth of private equity, and particularly leveraged buyouts. I think now that cheap finance has gone, and ultra-loose monetary policy has gone, private equity is having a difficult time.

Also, because the initial public offerings market is very sticky at the moment, it is very hard for private equity to sell back its portfolio of properties to the market, so they are having a pretty rough time. They have a lot of "dry powder"—committed funds from institutional investors, just sitting around not being put to work, because conditions are now very difficult.

Q7 **Mark Pawsey:** Have people in private equity who have gone out and done all these deals and borrowed all this money been exceptionally naive, in your view, because interest rates were never going to remain at the low levels that we have seen over the past 15 years? They were never going to last forever, were they?

John Plender: I don't think they were naive; they were cashing in on a wonderful windfall, and cashing in in a very big way, because private equity is a wonderful reward system. Their fees are phenomenal, both direct and indirect. So they have reaped a very big harvest. Now the going is tougher and they will reap a smaller harvest in future, but I don't think you could call them naive.

Q8 **Mark Pawsey:** What will be the consequences for those companies that have borrowed substantial sums of money, now that interest rates are higher? Can we expect to see a series of business failures, in your view?

John Plender: I think we certainly will see business failures, and there have been many business failures in private equity going back over the decades to the 1980s. I think you will see much poorer performance figures coming out of the industry and I think the going will be tougher for the institutional investors who back them, as well as for the fund managers.

Q9 **Mark Pawsey:** Mr Lagarias, coming back to you, why do you think we have seen so much investment by private equity into retail?

George Lagarias: They seize the opportunity and they go for it wherever they find it. What I am more worried—

Q10 **Mark Pawsey:** But why retail? What have been the circumstances of the retail market to make it attractive for private equity investment?

George Lagarias: Possibly its lower valuations and innovation. That is what drives private equity.

Mark Pawsey: Lower valuations and what?

George Lagarias: Lower valuations and innovation. In terms of retail, look at how retail behaviour has changed now that everything has gone online. So you add tech to the mix, and private equity is heavily exposed to tech, and that is why you see this interest.

Q11 **Mark Pawsey:** So it is a balance to the tech investment as being something that is more nuts and bolts as far as the economy is concerned. Okay. Are there any other sectors where you think you might expect to see private equity investment? If there is difficulty in retail, where might they go next?

George Lagarias: They have exposure in real estate, in energy, in raw materials, and generally consumption. These are the main areas, at least in the UK, where you would see private equity concentration.

Q12 **Charlotte Nichols:** Mr Plender, you have observed that private equity managers have turned to esoteric financing arrangements in response to shrinking markets for debt finance. What are the risks associated with such esoteric financial arrangements?

John Plender: Simply that the risk of bankruptcy among the portfolio companies is much greater.

Q13 **Charlotte Nichols:** Ms Houghton, obviously TDR Capital and the Issa brothers employ about 10% of the UK retail workforce through their ownership of Asda. What do those risks mean for Asda workers and the wider economy?

Nadine Houghton: Before I come on to that, you mentioned TDR Capital, and it is really important to point out that it is not here today. TDR Capital are co-owners of Asda, and my question is: are they above democratic accountability?

Chair: They are coming on 9 January.

Nadine Houghton: Well, that is really good news. They have very serious questions to answer. There is a £1.8 billion gap in the accounts. A £2.1 billion dividend has been declared, and we do not know where that has gone. Several serious accounting errors have been reported in the press. Asda are seeing a loss of market share. Their volumes are down, and there is intense pressure on retail workers, which I will come to in a minute. So far, TDR Capital has been unable to appoint a CEO to run Asda.

I was with this Committee only four weeks ago talking about the collapse of Wilko. That was 12,000 jobs lost. We are not saying that Asda is at crisis point. We want Asda to thrive. Tens of thousands of GMB members' jobs, rely on Asda being a successful business, and so do consumers and the supply chain.

We desperately do not want to have to come back here to raise concerns similar to those we raised about Wilko, and to have the same discussion that we had to have about it. That is why we are here today. We want to raise the alarm and say, "Our members are reporting issues from the shop floor. Can we make sure that we listen to them, to people on this panel, and the union that represents these workers, so that we avoid that type of crisis?".

Asda employs 140,000 people. We are talking about a huge impact on the economy, the supply chain and everything else if TDR Capital and the Issa brothers get this wrong. It is absolutely essential that TDR Capital be held to account. We were just discussing this; it gives private equity a bad name. They need to be here, and to be accountable for their actions.

May I go on to give examples from the shop floor?

Q14 **Charlotte Nichols:** On what the risk would mean, we have been discussing the general risk of private equity, but if things went wrong, what would that look like, hypothetically? I appreciate that you said that Asda is not in that position at the moment, but the Committee is trying to understand the risks associated with these kinds of structural arrangements, so it would be good to get a bit of an understanding of what it would mean if this went wrong, much as we all hope that it will not.

Nadine Houghton: As I have said, there are 140,000 jobs on the line. We are talking about many tens of thousands of jobs in the supply chain, and less competition in the retail market, which would have an impact on consumers, shoppers and the wider community.

Talking of examples of private equity in retail, we also have to consider that Morrisons is now owned by private equity. Only yesterday, their chief executive sounded the alarm about its levels of debt, the interest payments on that debt, and the fact that Morrisons will have to change if it is to survive. This is a CEO of what was once one of the big four retailers. Morrisons and Asda are losing market share to Aldi and Lidl; we are already starting to see that slide. The impact would be catastrophic.

Q15 **Charlotte Nichols:** Is it GMB's position that this is an appropriate way for a supermarket to be owned, and appropriate for ownership in retail?

Nadine Houghton: I do not think that we would comment on whether it is an appropriate way for a supermarket to be owned, but there are a lot of red flags. It is early doors enough for us to flag some of the issues, so that we can hopefully create the accountability and scrutiny required to avoid the mistakes that we have seen with the likes of AA, Southern Cross, Debenhams, and Wilko.

Q16 **Chair:** Which are the red flags that worry you most?

Nadine Houghton: Of course, there are the debt levels and the interest payments. But when we look back, for example, at what happened with Southern Cross—the largest care provider in the UK at the time of its collapse—which was private equity owned by Blackstone, we see some patterns developing. We see an intensification of workload on the shop floor. We see a lack of tools for the job. Some of our members reported, for example, having to buy biscuits for the residents because there just were not the funds to be able to do those things.

From an Asda perspective, we see a dramatic drop in hours available for shop floor workers, which is intensely increasing the pressure on them, their mental health and the work that they have to do. We have seen cuts to the cleaning contract. There is no longer a cleaning contract within Asda stores, so we are concerned about levels of cleanliness and maintenance.

We see health and safety problems popping up all over the shop in many different aspects. Violent attacks on our members are up 40%, and our members are being asked to achieve unrealistic productivity targets. I think it is a result of some of the issues that have already been described, which is that private equity has to pay back this debt somehow. One way we believe they are seeking to do that in Asda is through some of those examples from the shop floor.

Chair: I will come on to Andy McDonald in a second to ask you to generalise some of those observations, but I will bring in Mr Gullis first.

Q17 **Jonathan Gullis:** Ms Houghton, you pointed out what is happening in Asda stores. One concern we have, which I think was pointed out by the CMA, is the extreme pivot that Asda was having into the fuel sector in order to effectively try to cover losses it was making on the shop floor. How do you feel that has impacted the private equity deal? Do you think it is a strategy to focus more on trying to make funds through that until they come clean? Do you think that that is undermining workers and the retail shop itself?

Nadine Houghton: I think it was quite telling that when the Issa brothers and TDR Capital first bought Asda, they spoke about having no intentions to merge the EG Group operations with Asda, and then only over the summer we saw that merger taking place. Asda put out a lot of PR bumf at the time to say that it was about creating synergies—getting into the convenience market and selling Asda products within EG Group petrol stations.

From our perspective, it was about de-leveraging some of the huge debt pile that EG Group had amassed on to Asda's balance sheet. Actually, those synergies that they spoke about already existed: our members were already delivering Asda products to EG Group petrol stations. They already had access to those synergies, so it was about de-leveraging the debt from EG Group. Again, that is bad for workers because it means less opportunity to invest in the business and more pressure on workers on the shop floor.

Q18 **Andy McDonald:** Can I just wind back a little to the principle of how this works out for GMB members more broadly—not just at Asda, but those working for companies with private equity ownership? We have heard already about some of the background to private equity, in terms of management sitting alongside the equity funds, and we will come on to talk about the short-termism of these arrangements, but what is the experience of members more broadly across the sectors where private equity is involved? How does that manifest itself? I know you have talked about Southern Cross, but are there any other examples or experiences that you would like to share with us?

Nadine Houghton: GMB gave evidence in 2007 because the AA had been bought out by a private equity firm that had raided our members' pension pots and de-recognised the union. That was another example that GMB had directly with private equity, on top of our experiences with Southern

Cross. There is also the example of Debenhams; we are not recognised by Debenhams, but its collapse came about as a result of a private equity buy-out.

We are the union for Thames Water workers. Although that is not directly private equity-owned, there is a high level of debt. There are similar models and themes around debt leveraging, and using a parent company to hold that level of debt to avoid scrutiny from—in Thames Water's case—the regulator. Again, we see that theme of a complicated, complex ownership structure that allows private equity firms to evade accountability and stops us being able to ask questions about how the business is being run.

In the case of Asda, we have made formal financial disclosure requests around the gap in the operating costs and where the dividends are being declared to. We are being met with "Well, actually this is our parent company. You, GMB as a union, can't ask questions about the parent company, because you're only recognised by Asda." That is just about creating a structure that prevents working people from understanding what is happening in their employer and prevents their union from doing the job and representing those members.

Q19 **Andy McDonald:** You mentioned Debenhams and the structure that you found there. Are you saying that in those instances, of which Debenhams is not the only one, if there had been different structures sitting behind those companies—not the ones we are talking about today—the high street might have looked substantially different?

Nadine Houghton: If you look at Debenhams, a big part of the issue was that it failed to keep up with the times: it failed to modernise, it failed to invest, it failed to have a long-term strategy. That is a theme that we see developing around some of these private equity ownership structures. The UK has one of the most competitive retail markets in the whole world. In that sort of competitive market, it is essential that the owners of these businesses keep pace and invest for the long term.

Q20 **Andy McDonald:** Are you saying that that is how you view the current situation in Asda? As a supplementary to that, how does that manifest itself in the Asda family, in terms of industrial relations practices?

Nadine Houghton: I am saying that it is a theme around private equity-owned businesses. As I have said, the experiences of our members on the shop floor are of worsening health and safety standards and intense pressure. The analysis that we have done shows that there has been a reduction of 4 million hours on the shop floor, year on year. We have done some analysis for each Committee member to show the drop in hours in their local Asda store, just to give you an idea of what that looks like.

Yes, there have been industrial relations challenges as a result. Really, all we want is the best deal for our members, right? That is why we are here.

Q21 **Chair:** We have on screen a slide of the Asda corporate structure. As you can see, it is quite complicated. How easy is it for you to look through and judge questions of, say, how much debt the business has?

Nadine Houghton: It starts to become impenetrable. When we were trying to chase the £1.8 billion gap in operating costs, we eventually got to one of the companies registered in a tax haven.

Q22 **Chair:** In Jersey?

Nadine Houghton: Yes. We found that that company had been dissolved. Not only could we not get access to the accounts because it was a Jersey-based company, but that company no longer existed.

Q23 **Chair:** Is this a typical structure for a private equity-backed business, Professor Talmor?

Eli Talmor: Allow me to say a few things. First, I sympathise a lot with what Nadine says. I am not taking a different approach. However, I have been around the Debenhams deals and so on. On the issue of debt, let me stick to the numbers; I have the data. Private equity is more resilient to default than other companies holding the level of debt constant. The reason is that they use a very covenant-lite structure. All the data that I have is that the default rate is lower.

I will criticise in a minute—I will be balanced—but I should also stick to the record. In the pandemic, the highest numbers of deaths were in nursing homes. Some 40% of deaths happened in nursing homes, all across the world—you may remember what happened in Bergamo in Italy. I have here a study by my colleagues from California that shows that those that were held by private equity were better off in terms of equipment, readiness, nurses and protective equipment, and had a lower number of deaths and a lower number of cases in general.

The point is that it is not the general practice of private equity to starve the companies. The level of debt is not an issue. Yes, it is moderately higher than otherwise. You do stress the assets—sweat the assets—a little bit more. However, it is covenant-lite, as I mentioned.

I think the issue in retail is different. We saw it in Debenhams, I think we see it—I am not an expert—in Asda, and we saw it in other situations. The matter is the divestitures of the real estate. It was known at the time as the opco/propco model, through which you take a company like Debenhams and split it in two parts: the retail business and the real estate. It is very much like hotels. Hilton does not own the buildings, and the idea is that basically you do not provide the rent for free. There is one company that owns the assets, and the other one is running the commercial business: retail, department store, groceries. That is effectively another layer of debt, because on top of borrowing, now you need to serve the rent. That, I think, is largely ignored in the conversation, and private equity is rarely doing that any more.

Q24 **Chair:** George, have you any observations on whether this is a typical structure for a private equity business?

George Lagarias: From what I have seen, it is a typical structure. You would see this level of opacity in a lot of them. The issues with labour that Ms Houghton has described are very typical. I have seen it across a different industry 4,000 miles away: what she was describing was very close to home.

As far as the defaults are concerned, I have an inherent distrust towards numbers, because the industry was inflated in the past 14 years. This is a very different industry from 14 years ago. In those 14 years, it has also thrived because of cheap money. The industry, at its current size and at its current level, has not been through a liquidity crisis such as the one we are seeing today. Knowing what to expect based on those historical numbers, you might not get what you think you will get.

Q25 **Chair:** What will we get?

George Lagarias: I think that risks are elevated. Although I cannot hold a crystal ball and tell you exactly what we will get, it is my experience with crisis that things do not turn out the way our models tell us they are going to turn out.

Q26 **Chair:** John, have you any observations on this kind of structure? Does this create risks?

John Plender: I think that private equity is very good at minimising tax liabilities. I think this whole industry is built on two wonderful tax breaks for the managers. First, debt interest is a tax privilege relative to equity dividends. Secondly, the carry, which is what the private equity people call the performance fees they get, is treated as capital gains when it is very obviously income. Tax planning is very much at the heart of what these people do, and that the structures are very often complex for that reason.

Q27 **Chair:** We have 17 of these businesses that are registered in Jersey rather than in the UK. Why would somebody do that?

John Plender: On the details of tax planning, I am afraid I am not an expert, and I cannot give you a good answer. I suspect Eli might have a better answer to that.

Eli Talmor: The answer is yes.

Chair: The answer is yes, okay.

Eli Talmor: Those in private equity care a lot about reputation. They would not be able to raise the next fund if a labour union or the trustees of the pensions are upset. There are currently over 5,000 funds trying to raise, and very few of them will. For them, reputation is critical and hence there is a limit on how much they absorb.

I think we should also make a distinction, because being private and being equity is not the same as being private equity. A lot of the industry's bad name happened because of Philip Green and others. They are not private equity. They are not managing institutional money on behalf of others and needing to raise the money again in five years. I just wanted, for the protocol, to make that distinction. Not all private people who invest equity are private equity.

Chair: That is very useful. Thank you.

Q28 **Ian Lavery:** I am just looking at the structure, and it looks terribly complex to me. If it looks complex to me, I am not sure how complex it might look to the workforce who provide the finances for their company.

There has been a slight difference of opinion, I think. Mr Lagarias suggested that this was quite typical of a company like Asda, and I am not sure, Professor Talmor, whether you are in total agreement. Is there a difference of views on this?

Eli Talmor: I do not think so. I think that if you engage in this situation of splitting the operation from the assets, you get into this complex structure that I personally do not like. Otherwise, the fact that it is done offshore may have other reasons—because there are institutional investors coming from all over the world, and the structure is much simpler. Yes, it is offshore, but it is much simpler.

The core of the issue is stripping the assets. That is the point. Having that as a separate company adds another layer of monthly rental payments that have to be made. I did not go into the particular detail, so I cannot have an opinion about the petrol conflict of interest. I don't know if there are any conflicts of interests working there between the partners or the investors in the petrol station. Probably TDR will not allow it to happen. The issue of another layer of cost is something that definitely implies what Nadine said.

Q29 **Ian Lavery:** Did you agree with what Ms Houghton said about the GMB union being slightly concerned that this could be another Wilko? We had the collapse of Wilko retail only a few weeks ago.

Eli Talmor: Again, this is transitional capital. Retail, generally speaking, should not be in the hands of private equity. It should be in the stock market, because it is supposed to be a stable business. I do not see too many ups and downs in retail, and definitely not in grocery stores. It is a very immune, resilient industry in times of recession. People still buy food. For department stores, it is a different matter, because they have e-commerce issues. In grocery stores, that is not so common.

Q30 **Ian Lavery:** You have mentioned the resilience of private equity structures. They can be resilient to economic downturns, and they might deliver advantages for some companies compared with public markets. Can you explain to the Committee the virtues of private equity?

Eli Talmor: This is definitely one: you have hands-on engagement. It is engaged ownership, whereas in a listed company there is a huge gap between the management and the shareholders, who are dispersed and own only a few shares. Hence, the corporate board of governance does not have much impact. They are not very engaged. They are more policemen than a board that proactively sets up new policies. It is very different in private equity. They are there all the time. Where is that important? It is important particularly in bad times.

I usually give my students the example of a basketball coach. If your team is doing very well, you don't need to be a coach. You can go and have a beer outside. But if there is an issue and they aren't shooting, you need to take time out, rearrange and be involved. You cannot do that with a listed company. That is a huge advantage in the structure of engaged ownership.

There is also the fact that they need to exit the business, so they cannot be complacent about improving and unlocking value for the business. The general model is brilliant. There is a 10-year contract, and after five years you raise a fund again. If they do not like you, the unions or the pensions, they will not invest in you. That means something to the number of defaults or folds—we do not see companies folding in private equity, because that is it, the end of the game. The structure of the whole makes sense.

Ltd partners and institutional investors will always ask, not about the successful bids, but about the one that failed: "Why did it fail? What did you learn from your mistakes, Mr Fundraiser GP?" That attitude really holds feet to the fire at all times. It is a very correct structure. My wife says that marriage should be for 10 years and then we should consider whether to renew it, not take it for granted forever.

Companies in the stock market think that the money is there—that they are sitting on piles of cash. When we talk about criticism of private equity, I am not saying it is perfect, but what is the alternative? The alternative is being a listed company, and I can give you a whole page of issues about what is wrong with companies that are listed. For example, listed companies are followed by analysts. Analysts tell management what to do and what the expectations are—"You have revenue recognition issues", and so on. Another example with listed companies is that management do not have skin in the game; in fact, they get options or shares in the company free, whereas in private equity, management need to co-invest with the private equity. That is skin in the game, and it makes them so much more reliable and gives them alignment of interest, which is key to so many things that go on.

The industry has an amazing corporate structure. Again, reputation is paramount in that. You always need to meet your investor to explain; it is not like getting the money once and disappearing. You have to return it all the time. But there are definitely certain issues to discuss.

Q31 **Ian Lavery:** That is a great explanation, but what really concerns me is the fact that, as you mentioned, the private equity firm is basically not really bothered one way or the other about the workforce or the people who actually make the money for the companies. They give absolutely no credit to them, or listen to what is being said; the prime objective is to make as much money as they possibly can. It is chilling to hear it in such stark terms—I know you did not say exactly what I have just said, by the way—but thanks very much for that explanation. I think Nadine wanted to come in.

Nadine Houghton: Just to respond on the points about sale and leaseback, and private equity and care, I think you were giving a global example there about what happened during the pandemic. Our experience with Southern Cross was that £1.5 billion was taken out as profit disguised as rent and management fees.

If we look at the example of Asda—Eli spoke about sale and leaseback of properties—another theme of private equity is that Asda sold all the distribution centres, so all its warehouses, and leased them back through Blackstone. Blackstone was the private equity firm that owned Southern Cross at the time of its collapse. For Asda, that sale and leaseback process has added £1.17 billion of lease liabilities on to the balance sheet, with a 145% increase in the interest payment on its leases.

Again, that is the theme of what the private equity firms do. How does that help them to extract money out of the business? That £1.5 billion taken out of Southern Cross in rent and management fees brings us back to the questions that we have about this gap in the operating profits—this £1.8 billion and the declared dividend of £2.1 billion. Where has that gone? Is this money being skimmed off the top of Asda? Is it being taken out of Asda when it should be invested in the shopfloor and keeping prices competitive? We do not know the answer to those questions, because an impenetrable ownership structure prevents us from being able to get that information.

Q32 **Ian Lavery:** Mr Plender mentioned that the private equity firms basically had a good spell—to put it mildly—not so very long ago, but now they have fallen on harder times. Would you describe the private equity structures today as like growing pains, or are there other serious underlying flaws within the business model?

John Plender: I would say that there are a couple of major flaws in the business model. The first one is that private equity seeks to maximise financial efficiency and, in doing so, erodes the resilience of a lot of these businesses, and that is part of the story at Asda. The balance sheets are loaded with debt, which means that when you confront any kind of financial crisis or if you are in a downturn, these businesses are riskier than they used to be.

The other thing worth mentioning, though, is that this point about engaged ownership is right: there are some good things about the private equity corporate governance model. Having said that, the good bits are about the accountability of portfolio companies to the fund manager. The gap in accountability is from a fund manager to the institutional investors, who get very mixed-quality information about performance from private equity.

The performance numbers, first of all, are heavily dependent on the fund manager’s valuation of unsold companies. You see that particularly at the moment. If you are a trustee of a pension fund or involved in institutional investment with exposure to private equity and you are looking at the accounts to 31 March this year, in that year public equity saw considerable falls in value. Yet the private equity managers are reporting much smaller falls in value, which is totally counterintuitive because these are very highly leveraged businesses. Leverage amplifies returns on the up, and it amplifies losses on the way down. Private equity should now be reporting much worse figures than public equity, but it is not. I think you might conclude from that that these performance numbers are being smoothed and that a rather opaque and misleading picture is being drawn of what is happening to private equity in the downturn.

Q33 **Mark Pawsey:** Mr Plender, you have been writing on financial matters for many years. I am trying to draw conclusions from the evidence. We have Professor Talmor giving a robust defence of private equity and Nadine reminding us of some of the failures. You have just said yourself that performance is being smoothed. What are we going to do about it?

John Plender: The obvious thing is to say there should be a natural market response to this, which would be that institutional investors should think again about how far they wish to expose themselves to private equity. One has to acknowledge—even if you are a bit of a sceptic like me—that some private equity managers perform very well and can improve the underlying operational performance of businesses. But it is very hard for institutional investors to identify which ones can do that, partly because the performance reporting is so opaque.

Q34 **Mark Pawsey:** Is that because institutional investors do not ask the right questions or are not sufficiently demanding in the information they require? Or are they simply not able to get it?

John Plender: I think they have bought a lot of propaganda about the ability of private equity to outperform public equity. For a lot of the last two decades, pension funds have been in deficit, and they have been desperate to find ways of closing the gap and become solvent. The private equity industry claims to offer them the opportunity to earn an illiquidity premium over public equity.

Q35 **Mark Pawsey:** Maybe, during a period of low interest rates, it was able to do that. Is that right?

John Plender: Well, there is huge controversy over the performance numbers of private equity vis-à-vis public equity. You can find evidence going either way. All I would say to you is that the one thing that is very clear about private equity is that the amount the managers are gouging out in fees is so great that you have to outperform by a mile to make good that hole in the returns available to institutional shareholders.

Q36 **Mark Pawsey:** As a Committee, we will be drawing up a report making recommendations to Government. Are there any things Government should do about the deficit that you explained to us just now?

John Plender: I suppose that if you are worried about the systemic implications, for example, of very high levels of debt in private equity and what that might mean for the banking system as a whole, it would be possible for Government to think about whether limits should be put on levels of leverage in private equity. In my experience, the danger with doing that is that people in private markets are very good at gaming regulations of that kind. I am not really sure that that would work. I think it would be good if the Government could devote some time to doing a public examination of the way in which private equity reports to shareholders and how the performance figures are calculated.

Q37 **Mark Pawsey:** This Committee has done some work on audit reform, and many of us were disappointed that there were not any proposals for audit reform in the King's Speech, for example. Do you think there is a role for reform of the audit system? Are auditors getting the data that they want? Is it getting out into the public domain in the way that it ought to? We are looking at this structure and the use of Jersey-based companies to prevent exactly that kind of disclosure.

John Plender: That is a very good question. The private equity managers produce these valuations of their portfolio of companies that have not been sold. They usually get a big four accounting firm to review their valuations. I think there is a suspicion on some people's part that this is a rather cosy relationship because the big four accounting firms will often have other relationships with the private equity managers—for example, advising on that M&A activity and so forth. It would be possible for the accountancy and financial regulators to consider whether there should be further restrictions on the role that the auditors are allowed to play in relation to valuation as against other things where there may be conflicts of interest.

Q38 **Mark Pawsey:** Mr Lagarias, if you were in our seats making recommendations about the role of private equity, what would you be saying?

George Lagarias: Valuation is where it starts. If I give you £1 million for 1% of your business, that means that your business is now worth £100 million. You can now go to your friends and say, "I have a £100 million business. Invest with me", which they are going to do because £100 million is a lot of money. But you only have £1 million in your pocket, and you are just meeting operating expenses. Valuation is pretty much a thumbs-in-the-air practice. That is the reality of it. Sometimes it is based on who paid last, at what amount and for what percentage of the business. Sometimes it is all about cashflows. You can look at a company in many different ways and arrive at all sorts of different valuations. The first thing I would do is ensure that the valuation framework is robust and that there are guidelines.

Q39 **Mark Pawsey:** Whose job is that, Mr Lagarias? Is that the Government's job, or is that the financial institution's job?

George Lagarias: From slightly tangential experience, I have been involved in certain bank audits. I had a tussle, or a few, with the FRC, which was giving us guidelines. It is not up to the industry to self-regulate—let's be honest about that. Often, the FRC comes and says—

Q40 **Mark Pawsey:** Is that because the industry is incapable of self-regulation?

George Lagarias: It is because it is not its primary role to self-regulate. The industry's primary role is profitability.

Q41 **Mark Pawsey:** So whose job is it to regulate it?

George Lagarias: Again, I am no legislative expert, but I would assume the state.

Q42 **Mark Pawsey:** Nadine, what would you like to see change in terms of this structure?

Nadine Houghton: I was actually just laughing when Mr Lagarias spoke about valuation. TDR Capital announced that it had increased its investment in Asda by 20% only a year after buying Asda. It is of course a house of cards, isn't it? If you are only going to put a small amount of your own money into that investment, and the rest of it is fuelled by debt, then clearly there are questions to answer around valuation.

Q43 **Mark Pawsey:** But hold on, Professor Talmor was telling us that these were good organisations because they have skin in the game, they are putting their own money in and they are involved in managing it. That is not what Professor Talmor said.

Nadine Houghton: All deals are structured differently, are they not? I am here talking about Asda, and in the case of Asda, TDR Capital and the Issa brothers only put £400 million of their own money into a deal that I think was in the region of £7 billion. That is the reality of the Asda deal.

In terms of the role of the state, we believe that there is a role for the state here. The themes that you have heard today are really around transparency and accountability for private equity firms—looking at the ownership structure and everything else. We think that there is an expanded role for the CMA here. Section 58 of the Enterprise Act 2002 could give the CMA the power to scrutinise mergers or takeovers based on public interest or security.

Q44 **Mark Pawsey:** Would the fact that private equity is involved by definition involve the public interest, in your view?

Nadine Houghton: It is more about the fact that, actually, a critical retailer—a critical source of the UK's food supply—should be considered as an organisation that is in the public interest.

Q45 **Mark Pawsey:** So a whole range of businesses should be off-limits to private equity? Is that what you are telling us?

Nadine Houghton: No, I am not saying that a range of businesses are off-limits. What I am saying is that there is an expanded role for the CMA to be able to scrutinise these deals to ensure that they are being done in the interests of both the public and, from our perspective, the people that work for the companies as well.

Q46 **Mark Pawsey:** And Professor Talmor, the message from you is, "Nothing to see here; everything's hunky-dory".

Eli Talmor: I would like to make a quick three comments. First, private equity is primarily owned by the public through their pensions. That is the main beneficiary of private equity. Let us remember that our exposure to all of these companies is through our pensions, and that includes the universal one for employees.

Secondly, the idea about how they report the net asset value is absolutely irrelevant because—and frankly, that has already been regulated after the global financial crisis. Now that they are being measured, the investors will invest only on the grounds of cash-on-cash return net of all fees. That has been a 14% return over I would say the last 40 years, compared to 7% in the stock market, so they produced twice the return. And, again, that money goes to the union employees, to me as a pensioner and to everybody else.

The default rate of private equity is very low—not default but losses. Only 10% of private equity funds do not return the 100% that they actually took from the investors; 90% return above that, and many of them return much above. If you go to the stock market, clearly the number of defaults is so much more. Nobody loses more than 10% in any fund, so the level of risk is not high. I disagree that the default rate is higher in times of recession, and so on, because they are engaged. I even remember that Permira put more money in after their equity was actually negative because they believed in the business, so it is about patient capital.

You asked me about reforms; I should tell you that transparency is extremely high, but to the people who invest. The limited partners who invest get full information—full disclosure—about the deals and the cash flows in every one of those deals, and they will scrutinise it to the ends of it.

Chair: Okay, thank you. I am going to just wrap it up there because the time is against us. Very briefly, Mr McDonald, you were going to ask a question.

Q47 **Andy McDonald:** Yes, I just had a couple of things. Professor Talmor, you talked about transparency. You have seen this group structure. Those companies in orange are registered in Jersey. We cannot see what is going on there. How can it possibly be transparent if they are hidden behind those structures?

Eli Talmor: I am talking about best practice of private equity.

Andy McDonald: Best practice? Okay.

Eli Talmor: I am not—clearly there are, and I had my opinion about this—once you are engaged in sales and leaseback and start moving assets around, clearly you generate so much more confusion and so much more of a complicated structure, which I do not understand; I did not study that, so I—

Q48 **Andy McDonald:** No, but you can understand our concern. This is an important entity within our country, and it being structured in such an opaque way causes us grave concern. That is why we are we are worried about that.

Mr Plender, you talked about some of the rent and management fees being taxed as capital gains. What would be the consequences of equalising capital gains with income tax in this context? Would that be detrimental to this industry, or would it address a particular problem?

John Plender: It would be detrimental to the interests of the managers, who are, I would assert, the biggest beneficiaries of the private industry's returns. I certainly think that a big area for potential governmental reform is the tax system, because, both in terms of thinking about what created the conditions for the great financial crisis in 2008, and of looking at the accumulation of debt in private equity, this tax-privileging of debt has actually been bad for financial stability in this country and others.

Q49 **Andy McDonald:** That is fascinating, because Nigel Lawson actually equalised them back in the day. To finish, I have a quick question for Nadine. What reforms would you like to see to protect and amplify the space for workers in these structures? What improvement or amendment would you want to see?

Nadine Houghton: The closure of the carried tax interest loophole and a greater role for the CMA. We speak about establishing legally binding ownership standards for critical national retailers, which could be called, for example, the national grocery retail standard. That would be established jointly with trade unions and businesses, and there could be an inclusion of fit and proper tests for directors and a limit on the amount of leverage placed on critical retailers and, importantly, their parent companies.

In terms of workers, it is about our ability to access information and making sure that there is a bigger seat at the table for workers—whether that is through workers on boards or increasing the information we are entitled to see under the CAC process, whereby we are able to gain information around businesses in which we are recognised. I think it is about a greater role for the people who are experiencing what is happening on the shop floor and ensuring that their voices are elevated in this.

Chair: Thank you very much indeed. We are slightly over time—my apologies for that—so I will conclude this session. Thank you to all our witnesses. You have set the stage for this inquiry very nicely, and I am very grateful to you for your evidence today.