THE NETWORK
OF LEADERS
CRITICALEYE

Private Equity CEO Breakfast

June 2009

Date
June 2009

Chair

Matthew Blagg, CEO, Criticaleye

Contents

Context: the past and future of private equity

How will private equity change in the context of the downturn? Traditionally, PE (private equity) investment was made with a clear view of exit. Cheaper debt minimised the cost and risk of transactions so that PE houses could put in just ten to 15 per cent of the equity as their own money, take 20 per cent for themselves and give the rest back to their partners.

The market has clearly changed and according to one CEO at this Criticaleye event, a third of private equity funds will not survive the downturn. Although some think investors will continue and even increase PE investment, most agree that they will reduce their commitment to funds.

What does the future hold for private equity? Will PE houses shrink to become more specialised, niche players? Will institutional shareholders and pension funds regain more of a voice? Whatever the outcome, delegates thought changes would be short-term, simply playing to market conditions.

Understanding and sourcing private equity

According to delegates, PE firms can be categorised into three groups:

1. Large firms which, in the opinion of the group, have become too big such as Apax or CVC

2. Mid-range firms which typically have a 15-20 company portfolio and represent the ideal model. These firms generally don't monitor their companies closely, allowing management teams to run the businesses. At the same time, they offer good levels of knowledge on strategy and finance

3. Small firms which are usually venture capitalists. These organisations will actively look to back opportunities with a greater risk in return for a greater reward

When deciding which sized PE house to go with it's important not to over-gear despite the fact the market is becoming increasingly attractive. As one delegate said, "Private equity's not based on a 30 per cent return anymore; it's in the high single digits."

Packaging and valuing

CEOs looking for PE investment should be maximising the potential ROI on the business. They should be asking key questions to identify:

1. Where are the opportunities?

2. What are the assets?

3. Who makes up the management team?

One barrier to accessing private equity funds, in spite of market conditions in the downturn, is that leaders still over-value their businesses. "But," said a Member, "If you run a good company with decent operations and are looking for growth financing, then you aren't going to compromise your valuation just to bring in private equity – because you don't need to."

One company, which had been leveraged from seven to 32 times, found a solution, which turned debt to equity by calling on all debt holders to take a debt to equity conversion. The CEO involved wondered if the leveraging would then be able to go back to five or six. He also mentioned 'cramming', which could be the result of this strategy, because if it isn't successful the company will be pushed into administration by the majority of the debt holders. However, cramming may lead to tension between the debt providers and the private equity houses, especially where the debt providers see that they are effectively taking all of the risk in return for a fixed interest.

Private equity in the downturn

Nobody could have predicted the current financial turmoil, but equally delegates questioned why private equity houses had planned for nothing but rapid and sustained growth.

One Member described how he had brought up modelling different cycles with his private equity investors, who weren't keen on applying them. "In their eyes, it will never go through the credit committee," he explained.

Balance of power

One Member felt that the downturn had highlighted discrepancies in opinion between in-house company management and private equity executives. "The private equity guys are under the impression that they could manage companies through the downturn, while the management teams don't seem to recognise the value that private equity are bringing to the business."

The reality for many downturn-surviving, private equity-backed companies is that both parties contribute to success. Recognition of this might provide for smoother sailing, it was thought.

Contribution from private equity

Delegates commended private equity executives, who, in most cases, delivered on all commitments set out in the original contracts. "They did virtually everything they said they would; they brought a chairman in who I've learned more from in two years than from a whole series of other people throughout my career," said one CEO.

Another Member described how banking relationships have improved greatly following his private equity deal. "They seem to take huge comfort in the fact that any investment is triangular. Their attitude has changed greatly; they always want to know if the private equity house has approved it."

Most around the table agreed that improved banking relationships are a great perk to private equity. "They can invest the time to have these relationships at a higher level than you, as a CEO, can afford."

Current issues with private equity

One potentially contentious issue between private equity and management teams is dividend policy. One delegate explained "It's a ratchet. At 20 per cent, which is an enormous number, it creates huge cash flow problems that actually takes value out of the business for management. I fought hard against it, but it is there, no doubt, to ensure that this business gets exit by year five."

Private equity has become something of a 'dirty' word, in the last few months. There are investors who aren't certain they want to invest with general partners right now, people who would like to take a step back and observe rather than buy. These individuals will come back in a year's time and make a comeback when the model has changed.

Mood of the banking community

There is growing resentment in the banking community that private equity has done so well over the past decade with what is seen by the banks' as their money. Delegates thought that the banks would become more aggressive in this respect once they had gained a little more stability.

"They are already getting aggressive," claimed a Member. "As an example, you have banks which are offering very low mortgages, with very low interest rates and these won't change. But as soon as you come to negotiate, or if you want something else, they will come down hard, they do not want to have anything below margin." Until there is enough competition, this position won't change but delegates thought this wouldn't happen until the middle of 2010.

Indicators

Delegates were all keen to discuss indicators of market growth. This began with a discussion around GDP. One CEO described how his company navigated the recession in the 1980s and mapped the recovery to the GDP. He wondered what the group felt would be a key indicator this time round.

Macro indicators are very difficult to identify. Specific companies will be exposed to different external influences so this makes it an even harder call. The markets have been so unpredictable and surprising things happen in every industry. As an example, one delegate, described his attendance at an industry conference. He expected it to be lightly attended, with most executives getting their heads down and not spending time and money on things like conferences. When he arrived, he was surprised that it was exceptionally busy. Everyone was feeling very insecure, so they wanted to get out and talk to their counterparts to try and get a handle on what's going on.

In the first six months of 2009, more money has been raised through public offerings than has been raised at any time since the 1980s. Although these are slightly false statistics, they do indicate that people are moving back to the public market.

Unemployment is also interesting when looking at indicators. One CEO had examined his own customer demographic and concluded that although they are unlikely to be or become unemployed, their fear of unemployment is high, which informs their spending. This fear level is impossible to measure but a crucial indication of when spending might start again.

Opportunities

Operational excellence is crucial in a challenging economy and continued execution is vital. Delegates felt that focusing on opportunities rather than threats is uplifting and exciting. There are illogical areas that are doing very well, which is fascinating to observe. Unfortunately, in spite of the great opportunities, many private equity houses have a strict ‘no expansion’ rule and it is very difficult to convince them otherwise. Many think that private equity will be half its size when we emerge from this downturn.

Role of institutional investors

One delegate felt that the major PE transactions over the past few years, such as AA-Saga or Boots, should not have happened as these were scenarios where institutional shareholders, namely pension funds, could have taken the reins and created value.

Another Member felt that institutional investors’ were to blame for the establishment of structures and incentive arrangements that have led to the current short-termism. The funds from institutional investors are ultimately long-term so individuals need to reflect this in their thinking.

But, said another CEO, one of the reasons institutional shareholders got involved with private equity was because they didn’t have the skills and resources to demand quoted companies to do what they thought they should be doing as they are often just analysts – not managers.

However, the private equity model didn’t begin as a short-term one. It became that way due to the availability of debt, the ease of exits with IPOs and because of the many secondary deals going on among many funds. Institutional investors then, thought another Member, got involved in what they thought was a longer-term investment, but it became short in this one ‘huff and puff’.

Criticaleye (http://www.criticaleye.net), as a community of senior executives, provides members with an experiential platform that allows them to innovate and develop by sharing business experiences and expertise with their peers from different industries/functions. For more information on Executive Membership please contact Tom Beedham on +44 (0)20 7350 5104 or tb@criticaleye.net