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Private Equity Retreat 2012

"Geographic expansion requires innovation, it is the key to growth given the current market conditions"

"In a sponsor-to-sponsor deal, you are often just delaying the problems in a business"

"70% of the $2 trn that's in the ground is out of the carry for GPs"

"Private equity funds and institutions have a superior ownership and governance model to the public markets"

"It's no great surprise that we see PE having to create value by being better practitioners with the people who run the businesses"

"We have to be seen to be part of the real economy, to be part of factories, not finance"

"PE is vastly over-funded at the moment: there's far too much dry powder chasing too few deals"

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Please note, to facilitate open discussion, Criticaleye's debates are run under the 'Chatham House Rule', ensuring that no material gathered is attributed to either the attendees or their organisations

INTRODUCTION

The exit was the focus for Criticaleye's first ever Private Equity Retreat. Just how do you achieve a lucrative sale in markets that continue to test the experience and skills of management teams, investors and advisors?

Although the exit journey will vary from business to business, it was clear that driving growth involved management teams combining ruthless focus with a newfound flexibility and agility in how they responded to both challenges and opportunities.

A Member explained: "Most of our competitors are part of bigger corporates and their lifecycle on making changes on innovation and new product development is much longer. I can make a capex decision in a day if I think it is right, whereas it will take some of our competitors six to 12 month to get through a number of gateways before they've even decided to do it, so agility is important."

An international strategy was also deemed crucial – the question here was whether management teams possessed the skills and know-how to make it happen. Those executive teams who were up to the task, developing scalable models via organic growth and acquisitions, are successfully transforming their UK-centric companies into international powerhouses.

"There are lots of pockets of growth in the global economy, so we need to be careful that we don't get subsumed into thinking all things are bad," a Member explained. "It's a fun world, it's a complex world, but it's a world where we as leaders have to be able to interpret it and help our lieutenants understand it, and I think agility is the name of the game."

ALL CHANGE

Certainly, within the PE industry, it's a case of adapt or die. A large number of firms are stuck in limbo – they can't sell their portfolio companies, or at least not for the price they need to create a return, and they're unable to raise new funds.

Within many firms today, there are younger partners who have never had a successful exit under their belt. Undoubtedly, over the next couple of years, firms will disappear and the industry, as an asset class, will shrink.

Perhaps that is not such a bad thing as many existing funds sprung up from the credit boom. In the long run, this reality check could be good for the industry, although that isn't to underestimate the short-term pain of zombie firms, out of pocket investors and management teams simply running to stand still.

In terms of exit options, the overall view was that secondary deals are going to continue apace but, as ever, trade is the most favourable option because it's where the highest price can be brokered.

> *"Certainly, within the PE industry, it's a case of adapt or die"*

Across each session, the overriding theme was that those PE firms that generated real value for companies are the ones that will prosper, and the rest need to catch up fast. Going forward, there has to be an understanding of entrepreneurship and why genuine innovation and risk taking creates a winning competitive advantage.

Importantly, as an industry, PE needs to forge a positive reputation, building trust with politicians, regulators and the media. It has to be better at explaining why this model for investment is a positive force for the economy and society as a whole, so that it's recognised as a vital accelerant for growth which turns smaller companies into tomorrow's blue-chips.

This year's Retreat brought together CEOs and Chairmen who between them had generated exit values of well over £4 billion. The debate was insightful, frank and challenging. Encouragingly, despite the economic doom and gloom, the overall mood was upbeat as, with the right management team and bold thinking, companies can and will be sold for compelling prices.

Over the following pages, you can find out how it's being done.

Yours,

Matthew Blagg
CEO
Criticaleye

FINANCE vs VALUE

Private equity has to get back to doing what it does best

The economic and political volatility around the world may make it hard for businesses to map out a growth strategy, but the real problem around planning for expansion keeps coming back to finance.

The view among Members in this session was that, in regards to accessing debt and working capital facilities, things are not going to improve dramatically in the near future.

It was widely agreed that the giddy heights of 2003 to 2007 have gone and it was futile to try and base a strategy on those market conditions returning.

"Financial engineering helped a lot of value creation in the short term, but it's more difficult now and it's no great surprise to see private equity houses having to be better practitioners with the people who run the business in order to create value," a Member said, noting that debt funds would emerge to bridge the financing gap.

DEADLINE DAY

It's no secret that a significant number of PE firms are struggling due to the limited access to debt and financial arbitrage. PE firms raised a huge amount of capital from investors in 2006 to 2007 and that money either needs to be returned or invested over the coming year.

"If those funds haven't been spent, they will be retired," a Member said. "About 60 per cent of the dry powder in the European market comes from funds raised in 2006, 2007 or 2008; so it's a very large part of what's sitting out there in the market – causing some distortions in the way that completion is working within the space."

The amount that needs to be returned was estimated to be $1 trillion. In addition to this, there's approximately $2 trillion which has been invested into portfolio companies which are yet to be sold by firms.

"A lot of this comes from the heady days of 2006 to 2008 when there were large, debt-fuelled deals. The approach then was to see what debt could be obtained, leverage a deal and then try and learn something about the company – rather than the other way around.

"There's still concern among LPs about whether they're going to get their money back on a whole lot of those deals and there is a huge amount of work to be put in by firms. Again, this will clear over the coming year or so, although unfortunately this is happening at a slower rate than some might have hoped for. About 70 per cent of the $2 trillion that's in the ground is actually out of the carry for GPs, so it's valued at less than 1.5x what they paid for it – which means roughly you're not going to be able to carry, given the 7 to 8 per cent hurdle per year."

Accenture's Mark Spelman reveals how businesses can succeed despite the global economic risks

One Member argued that the situation was not quite so time pressured. Rather than return unspent funds over the next couple of years, firms would ask investors for an extension to the lifecycle of funds and that this would invariably be granted.

OUT OF THE ASHES

Fundamentally, the message was that there will be a contraction of the private equity asset class over the next couple of years as new funds are now much harder to raise and returns will not be made on many investments completed during the boom years.

In the meantime, market conditions will remain difficult. "Clearly, for PE sellers, they don't want to agree a deal that won't put them in the carry so they will hold on until they see a return," a Member said. "As for corporates, they're reasonably cash rich so they are not going to sell if they don't need to as liquidity is not a major issue."

Quick wins are going to be rare occurrences. For the majority of PE firms it's case of working closely with management teams to navigate highly volatile markets in order to build lasting value. ■

Key Takeouts

- Leverage will remain scarce
- Debt funds are on the rise
- PE firms need to get better at growing real businesses
- As an asset class, PE will shrink over the coming years
- New regulations make lending harder for banks

WHERE'S THE EXIT?

Vendors continue to pine for perfect buyers

Trade buyers are typically the preferred option for both management teams and private equity firms when looking for an exit, assuming the vendor is able to command a price that satisfies all parties.

"One of the elementary things to get right is to know your trade buyers and speak to them regularly, which applies to both management and the private equity partners," a Member said. "It's important to make a potential buyer feel as though they are getting preferential access to what you're doing."

NUMBER CRUNCHING

The downside of a trade buyer is that they tend to be slower as they mull strategic synergies to be gained and conduct highly detailed programmes of due diligence. Another potential problem to factor in during a trade deal is that information leaks out more easily, which can create issues with employees, customers, suppliers and other trading partners.

Although the price may not be so full for a secondary transaction, Members agreed that a distinct advantage was that as PE firms are set up for the express purpose of getting deals done, they can move quickly. The other positive was that, for management teams who felt an exit from their current sponsor was premature, a secondary presented another chance to generate greater a value.

Another area of agreement was that the executive team needed to drive a sale. "Management understands the industry much better than anyone else involved in the process – the bankers and the private equity owners. We know the industry players, we understand how our P&L affects the P&L of other people in the industry, and that's very important," a Member said.

Although conditions did present a perfect storm for trade buyers, the expected rush of deals was yet to materialise. A Member said: "We've had a number of cases where we really felt trade was the most likely exit route, but it seems that buyers with pockets of cash are becoming very selective and, frankly, a lot more risk averse than we've seen in the last two or three years. By contrast, there is a lot of interest from PE, but only for really good investments and assets."

DEAL OR NO DEAL

Other sources of deal activity were identified in the shape of distressed acquisitions, along with a rise in MBOs as corporates sort to dispose of non-core assets. But generally, the main dealflow is to come from secondary and tertiary buy-outs as, effectively, PE firms churned their portfolio companies, especially in the bigger PE houses.

Trade or secondary? Panellists discuss the exit options for businesses over the next 12 to 18 months

One Member questioned the cycle of deals: "In a sponsor-to-sponsor deal, you are often just delaying the problems in a business and eventually you are going to run out of road.

"You've got guys who are coming to the end of their fund and they have a sell-by date, and there are guys who have raised a new fund and they want to put money to work so they can start charging management fees."

Management teams needed to be wary of getting caught in a churn of secondary and tertiary transactions, where businesses have become simple vehicles for debt multiples and arbitrage.

The other barrier to deals relates to vendor expectations. "There is still a lot of belief among sellers that things will get better and that they should hold onto assets, rather than sell them at knock-down prices."

So a lot of firms are caught between a rock and a hard place. If they sell companies at too low a price, they won't get the returns they need and in essence they are putting themselves out of business.

The alternative is equally unattractive: hold onto assets and wait for an uptick in valuations, which few believe is going to happen any time soon. ■

Key Takeouts

- Get to know your buyers pre-sale
- Trade buyers are slow but pay a strategic premium
- Management must drive the sale process
- A secondary can be executed quickly and can lead to the creation of greater value but...
- ... are secondary deals going to run out of road?

INTERNATIONAL EXPANSION

Firms have to get smarter about supporting portfolio companies

If UK companies are to achieve turbo-charged growth, they need a plan for internationalisation. On the downside, going overseas is also one of the quickest ways to burn cash, make mistakes and seriously flounder.

In order to build confidence and gain traction in new markets, it was argued that you have to be bold and to devise a model that can be replicated and shown to be scalable.

"If you look at what competitors are doing and you fundamentally doing and you fundamentally believe they're doing it wrong, then actually go and challenge the status quo," a Member said. "We've asked for things from partners in other countries that no one had asked before, but it's proven to be a significant growth opportunity for us and our partners, so it's been the right strategy."

Interestingly, it was noted that putting innovation and product development at the heart of a business was fundamental when looking to enter new markets. "The view has been that if I can do something differently, I will, because actually it gives us a bigger return on our buck, rather than trying to do things the same as the competition. It's where we've experienced our growth," a Member said.

Many other Members agreed with this philosophy. "Geographic expansion requires innovation, it is the key to growth given the current market conditions," said one. "You have to experiment with different approaches and products."

There was some criticism of certain players within the private equity industry who, it was suggested, were too risk averse. "Innovation is inherently unpredictable and my experience of private equity is that they don't like 'unpredictable' and so I think there is a tension there," a Member said.

Growth today requires more than hiring a competent Finance Director and an aggressive sales team that know how to use a CRM system.

At present, many partners lacked the expertise, know-how and contacts to provide meaningful assistance to management teams, although it was acknowledged that a number of firms are actively addressing this lack of skills and resource.

ON MESSAGE

For CEOs looking to build empires, a key challenge is ensuring that a business maintains a level of consistency, which means clocking up the air miles and doing face-to-face meetings.

Panellists exchange views on whether the funding environment will ease up for businesses

"Partners expect to see the CEO. They want to know you're around and know the context behind the decisions you're making," a Member said.

Compliance with branding and marketing had to be watched closely, which again meant that relationships were worked on so partners in other countries could understand the value of a particular initiative, as opposed to allowing them to go off-piste.

Ultimately, if that integration and alignment was to happen properly, then it's vital to hire the right people. "We've now put in relevant General Managers and MDs to run each of these regions where they've got direct experience in terms of the models we're trying to deploy," a Member said.

Success often hinged on transforming a UK company, with its distinct culture, into a genuinely international business which had a clear goal and purpose notwithstanding the regional and geographical differences. "It's all about communication and engagement," a Member said.

Quite simply, if a company stayed UK-focused, a flat performance was the best many could hope for given the country's economic malaise. "The international strategy is everything," a Member said. ■

Key Takeouts

- PE is too risk averse
- Success in new markets depends on innovation and NPD
- Marketing and branding must be watched closely
- Many PE firms lack the skills for international growth
- Build a model which can be scaled in other countries

THE FUTURE OF PRIVATE EQUITY

Can PE be trusted to drive real economic growth?

At its best, private equity is a proven tool for enabling businesses to grow, thereby creating jobs and wealth. "This industry is part of real Britain and the real economy," a Member said.

It was seen as vital for the industry to get this message across as there continues to be concerns about the true motives of PE from politicians and regulators, both in the UK and Europe.

Greater transparency, especially over remuneration and taxes, and better communication are required so that the good stories are told. "Private equity is a methodology by which companies are owned in a sensible way, for the long term, where value is added because it builds better businesses," a Member said.

Without this, regulators in particular will continue to push for PE to be reined in through tighter controls and taxes.

Encouragingly, the different players within the industry, from those in venture capital and mid-market firms to the big buy-out houses, have become better and more sophisticated at working together so they can respond appropriately to the accusations of being asset-strippers and casino capitalists.

An example of this is that there may soon be reports on the external rate of return produced by firms. As opposed to simply measuring the IRR from an investment, firms will be able to demonstrate the positive impact on society, such as job creation for local communities.

MONEY WORRIES

The LP and GP model is under fire at present, not just in terms of scrutiny from regulators but among those within the industry itself as firms struggle to both spend the capital they have and to raise new funds from investors.

Despite the concerns raised, other Members defended the LP and GP dynamic. They argued that it was a proven and effective way to back businesses, although some acknowledged that certain refinements may be needed in order to make it easier to raise funds. "The model will evolve but the fundamentals of the Limited Partnership will remain because it works," a Member said.

Compared to the public markets, the model was seen to deliver extra value and levels of governance. "The relationship that private equity funds and institutions have is a superior ownership and governance model to the public markets," a Member said.

If private equity can get its levels of transparency right and trust is restored, then it has a strong role to play not only in the regeneration of the UK economy, but in assisting growth businesses globally. "Many countries around the world see this as an enormously positive source of change and growth and as a way to build great managements teams," a Member said.

Criticaleye CEO Matthew Blagg fields questions on what's next for the private equity industry

YOUNG BLOOD

The hunger for entrepreneurship was a great source of optimism for Members, especially when seen among younger people. A Member said: "When I came out of university, I wanted to be an investment banker – that was what was sexy and great back then. But these young people want to run their own business, which is fantastic and should be celebrated."

In the UK, there were more new start-ups last year than ever before. "That's the fantastic thing about what we do," a Member said. "People out there always find ways of doing something great, and we in the private equity industry have an amazing privilege to interact with them and help them to do it better."

In its current guise, PE is barely 30-years old as an industry. If it keeps maturing and builds confidence through its interaction with regulators, politicians and the public, then it is perfectly placed to become a major accelerant for economic growth. ■

Key Takeouts

- PE has to show why it is a force for good
- Transparency is key for PE
- The LP model will prevail
- More young people than ever now want to start a business
- London is the global heartland for PE

"That's the fantastic thing about what we do. People out there always find ways of doing something great, and we in the private equity industry have an amazing privilege to interact with them and help them do it better"