Beauty or the beast?

Private equity's bad rap has spread from trade unions to vendors to Brussels. The industry will overcome this for myriad reasons: its attempts to stave off negativity; its ability to efficiently execute deals and, most of all, the fact that sellers may have little choice.

By Taraneh Ghajar

The industry buzz surrounding private equity investments made now and deal flow through the next two to three years is overwhelmingly confident. If you have the cash to invest, reduced prices should yield high returns. But private equity's image going forward, both with banks and targeted acquisitions, has been dented. Getting a foot in the door as a buyer might well prove to be tough. As more than a few well-known portfolio companies fail to survive, how willing are banks to lend and how eager are companies to sell?

RBS is a perfect example of the faltering and pussyfooting that can take place as an outcome of the industry's reputation damage. When the sale of the UK insurance operations was first announced, RBS shunned private equity buyers, sending a sales memorandum to eight strategic bidders including AIG and Berkshire Hathaway. After most of the targeted bidders dropped out, the flirtation with private equity began.

"Banks recognise private equity's value both in terms of fresh liquidity and particularly specific industry expertise. The key is unlocking it," comments Andrew Lynn, a director at Hawkpoint's debt advisory team.

RBS rejected outright two sizeable bids for its insurance business. The first saw CVC Capital Partners attempt to acquire a 51% stake in the business, valuing it at £6bn; just last month, BC Partners and Apollo teamed up to offer a £5bn deal. RBS initially attributed its decision not to play ball to low valuations but eventually the bank confessed to having misgivings about private equity's ability to finance the offer. Despite 10 months of market time, RBS Insurance will now remain a part of the RBS Group.

As one of the top five UK lenders to buyout transactions in the UK, one has to wonder how much of RBS's recent qualms over private equity financing are influenced by the sizeable government bailout of public funds that was pumped into the bank last October.

"Banks are getting told by the government to focus on homeowners and small businesses, and I think there's a feeling in the private equity industry that supporting buyouts is currently perceived as a low priority," says Christiian Marriott, director of investor relations at Barclays Private Equity.

Cash is king

Private equity's reputation within the industry is doing fine, according to David Gray of sell-side corporate financier Cavendish. He is unconcerned with external attacks from mainstream media that focus on management fees. "The fat-cat perception from laymen doesn't influence my clients," he comments. "They are looking to maximise value and private equity's money is as good as anyone else's."

Identifying deliverability as one of the more pertinent issues for company sales right now, Gray points out that if a private equity buyer can take a 'one-check' approach – meaning the GP speaks with a lender in advance to receive assurance that funding will be there after they write the check, with possible refinancing after the transaction occurs – and act as a trade buyer, sales go through. "Deliverability has always been an issue, but particularly now. There is skepticism related to the use of bank debt as a large part of private equity's armoury, and the amount of leverage in the old model," says Gray, which the one-check approach eliminates.

Although positive about vendor pragmatism and amenability to lower valuations, Gray was clear about the overall drop in sales volume. "There is a scarcity of buyers compared to the halcyon days. Uncertainty is the enemy of M&A activity."

It takes two to tango

It seems the true crux of private equity's current difficulties, both in financing deals and preserving existing portfolio companies, is the decline of the lender-private equity relationship. Inaction in the market due to capital scarcity is exacerbated by an attitude shift on both sides. Opinion varies on whether banks are unwilling or unable to issue new loans.

"It's all about relationships," said Gray, in regard to any of the deals that get done in the current climate. "Relationships really are the key."

Lynn breaks the private equity bank relationship down on a case-by-case basis rather than a sweeping sentiment. "Banks don't want to own businesses. In situations where the value breaks in the debt and, perhaps, a sponsor has already recovered its investment through an earlier re-capitalisation, banks might court fresh cash and a fresh perspective. There could be room there for a different private equity group to come in."

Recent deal activity, like Yorkshire Bank's £18.5m debt package for the LDC buyout of Quantum Specials, also indicates that the leverage is available at some levels. "We're open for business," guarantees Mike Selina, a director in Yorkshire's corporate finance department, who led the transaction. "On the LDC deal, other banks were interested, which shows that a debt market exists for the right deal. We won it through the strength of our relationship."

Selina went on to add that the widespread belief that there is absolutely zero leverage to be had is part of the hold-up. "There is a perception among financial sponsors that there is no debt market. This is not correct, but lending criteria is certainly tighter and leverage multiples have come down. The perception that there is no debt at all is a limiting factor in the number of transactions coming to market." It seems that misperceptions across the board, whether a lack of faith in private equity's ability to create value or banks' ability to lend, has a negative impact on deal activity.

Yet even if banks have some leverage and are willing to back GPs, a negative perception of private equity becomes more apparent for existing portfolio companies that fail to earn. The British Private Equity and Venture Capital Association (BVCA) is even collecting examples of bank aggression in restructurings involving portfolio companies, with the intention of encouraging a better rescue culture between buyout groups and lenders. There is perceptible bitterness on both sides.

"Reputation comes up more frequently as an issue with existing portfolio companies than in new deals, but the dynamic of GP relationships with lending banks is changing, as the acquisition finance team you worked with may no longer be around, and under-performing companies may be passed along to the work-out teams far sooner than they used to be," Marriott points out. As portfolio earnings fall, banks don't have the time or the trust to put into restructures.

Other issues that have arisen in buyout lender relations also include colossal increases in the annual cost of renewing short-term overdraft facilities. Barclays and HBOS are among banks that have made overdraft fees so steep that many firms are opting to do without, a return to an older industry practice where deals were smaller and just took longer.

Other industry members feel a perceptible attitude shift where banks once treated private equity as a valued client; they now feel an imperative need to re-price cheap boom-year leverage and charge an increased fee. Whether this is in line with increased capital costs or a reaction to industry scrutiny is tricky to disentangle. It is clear that GPs will have to put their recent fundraising caches to work.

"I think there is a common misperception in the wider financial world that private equity simply doesn't work without massive leverage. Going forward it should be possible to achieve returns with lower leverage and the successful firms will be the ones that can make that work," says Marriott.

Targeted or justifiably tarnished?

The blemishes on private equity's reputation come from more than one source, and fat management fees for mega funds are on the top of the list. "I don't imagine the industry will see vast carried interest payments in 2009, so might get less attention on that front, although management fees on funds that aren't being invested may be a more pressing perception issue," cautions Marriott.

"Banks and hedge funds seem to be in the spotlight more than private equity," he says of the maelstrom now centered on the hedge funds industry and the plans to target hedge funds with a global regulatory system. "But I can see that changing if private equity-owned household names get into serious difficulties that end up in restructurings or business failures."

This is likely to come as many deals from 2005-2007 struggle in the next few months. Job loss associated with portfolio company insolvency is also a major issue. It comes up more frequently as firms attempt to preserve value in portfolio companies during restructurings, digging deep to cut costs.

Despite the fact that many private equity firms have a lot of un-invested capital, it is unlikely that this 'dry powder' will be put towards preventing human losses in existing investments. Trade unions have been especially vocal, the UNI Global Union is one in particular to put the heat on private equity, asking the industry to define what they will do to demonstrate social responsibility.

"The job loss issue has little to do with the ownership model," observes Lynn. "People recognise that it is a function of the fundamental economic downturn."

Lynn points out that the pure model of private equity that we will see going forward, one free from financial engineering, should actually result in job creation.

If the mostly symbolic public action taken by 13 of the largest US buyout houses before the UN seems to substantiate image concern felt by private equity players, then the EU hearing on 26 February on private equity regulation should raise the alarm. While the UN Private Equity Council was an initiative to promote self regulation, the EU definitively ruled that EVCA's self regulation proposal was not enough. Internal Market Commissioner Charlie McCreevey, who previously avoided regulating private equity asserting that it was not responsible for the current crisis, is under intense pressure to push a regulatory scheme for equity through before the June elections. The EU Socialist Party is the active vocal element adding private equity to the scapegoat list for global financial destabilisation. European private equity firms will face changes in the year ahead and may try to shine up their own reputation before socialists, LPs, labor unions, and high street shoppers start throwing tomatoes.

"Private equity needs to be more than reactive going forward, but you have to prioritise: CSR issues are important but right now I think GPs need to be careful about beating the CSR drum too loudly if they have more fundamental problems to deal with, like supporting portfolio companies through this difficult market," Marriott stresses.

Whether or not private equity players need to get vocal about the benefits of private equity investing, the market facts in combination with the EU's regulatory involvement should enforce a shift toward greater transparency and normalised returns. Players across the board are demanding more information up front from one another.

"I see this as a positive opportunity for private equity in the leverage space that has opened through necessity. If banks are not a source of liquidity, then private equity firms that have been fundraising could be. In this environment, companies are less likely to close the door on a private equity solution," says Lynn.

Selina sets the bar for which GPs can benefit going forward, pointing out that portfolio company care also sets the tone for bank-GP relations. "The private equity firms that will prosper are those that have a more hands-on approach to their investments/management teams. Private equity that actively supports portfolio companies, who sit on the board, can charter choppy waters and prosper as a result. As a bank we take comfort in that approach," Selina summarises. ■

> "Reputation comes up more frequently as an issue with existing portfolio companies than in new deals, but the dynamic of GP relationships with lending banks is changing, as the acquisition finance team you worked with may no longer be around, and under-performing companies may be passed along to the work-out teams far sooner than they used to be"
> Christiian Marriott, Barclays Private Equity