ARTICLE

'Constructive Interference' – A Much-Needed New Approach from Private Equity in the Restructuring Market?

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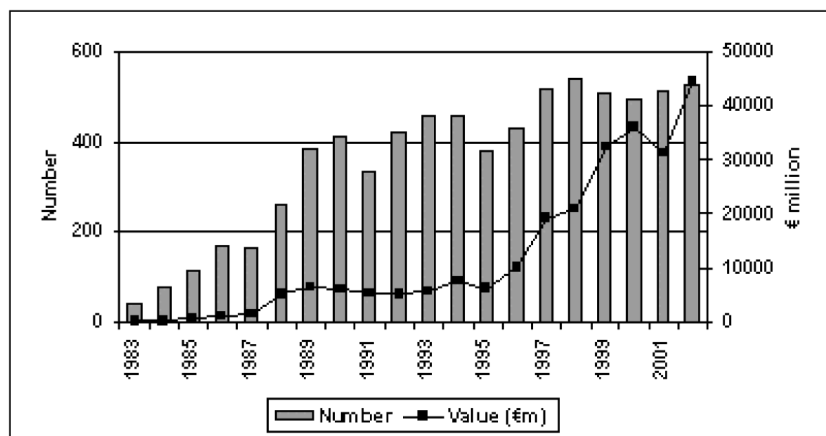
A scan of the financial press on almost any day would throw out one or more transactions involving private equity houses and would begin to give a sense of what a key role the industry is playing in financing business and corporate activity both here in the UK and overseas. Such that the recent announcements that the AA, the roadside assistance to financial services group, is to be sold by Centrica, to CVC Capital Partners and Permira for GBP 1.75 billion, or that Terra Firma the buyout group has beaten off competition from rivals to acquire two of the UK's leading cinema chains Odeon and UCI for close to GBP 600 million, rather than being the exception, are just two more in an increasingly long line of private equity funded LBO deals. With the traditional exit routes of IPO and trade sale having been relatively closed over the last few years, private equity has provided both the fuel and drive for a significant proportion of the corporate transactions in many markets across the globe. As a result, there is now a proliferation of private equity funds, ranging from small regional players to those who operate globally with USD billions to invest. In the UK alone, the BVCA has over 160 members.

To understand the likelihood of private equity therefore becoming an increasingly key stakeholder in the restructuring arena, one has only to look at the scale of the investment that has gone on in recent years.

In the European market, off the back of the technology bubble, fundraising by private equity houses peaked in 2000 at EUR 48 billion. EUR 35 billion was invested that year alone and, overall, European private equity houses have invested a staggering EUR 127 billion since 1999 (Source: *EVCA 2003 Yearbook*). Given the historic norm on investment lifecycles of 3 to 5 years (of this more later) and the vintage of these funds, much of this cash pile has now been invested. However, despite some of the market difficulties both domestically and internationally over the same period, the thirst of investors into private equity funds has seemingly not been quenched. Many private equity houses are out building new war chests and an increasing proportion of funds being invested by institutional investors are being allocated to this category. For example, Permira, which has recently been attempting to acquire the retailer W H Smiths for GBP 940 million, has raised the largest ever fund for a European private equity house of EUR 5.1 billion (Source: *Financial News*). In fact, of the funds raised in 2003, two-thirds were into Permira or Texas Pacific Group mega funds, and only recently EQT, the Nordic-based private equity firm, closed its latest fund at EUR 2.5 billion just six months after launch and in excess of an original target of EUR 2 billion..

As the funds have got larger so have the deals. LBO deal sizes have gone up by a factor of 15 since the 1990s. There is also an increase in 'club deals' with



Buy out trends in Europe

private equity mirroring the approach of banks in syndicating larger deals, thus enabling private equity houses to buy some of the largest businesses in Europe. For example the largest buy-out in Europe in 2003 was the sale by Telecom Italia of Seat Pagine Cialle, for EUR 5.7 billion, to a consortium of private equity houses comprising BC Partners, CVC Capital Partners, Investitori Associati and Permira. Other major LBOs in 2003 included the sale of Spirit, the UK-managed pub operator, by Scottish & Newcastle to CVC Capital Partners, Blackstone, Texas Pacific Group and Merrill Lynch Private Equity for EUR 3.6 billion, Kabel Deutschland, the largest European cable television network, by Deutsche Telecom to Apax Partners, Goldman Sachs and Providence for EUR 1.8 billion, and Immarsat, owner and operator of global satellite network for mobile communication, to Apax Partners and Permira for EUR 1.3 billion (Source: *Financial News (Private Equity) and Dealogic*).

As a result, there is a divergence in the market, with the likes of Permira moving into the super LBO market to compete with houses like Texas Pacific Group and KKR. In contrast, it is likely that some of the other more traditional houses that have not performed so well over the last 3 to 4 years will struggle to raise the size of funds necessary to compete in the 'Premier League'.

This huge increase in deal volume and size, coupled with some of the quite aggressive debt and amortization profiles put in place, would suggest that these funds need to become an increasingly common and active stakeholder in any restructuring. However, many restructuring professionals, and other stakeholders' experience of private equity in the more distressed scenarios, has often been that of waking up to the problem too late and therefore possibly out of time and underwater or relatively uninterested. Even with a potential key role to play, not least since they may be best placed to provide additional liquidity, houses have often been loath to take a seat at the table and commit relatively scarce internal management resources to a prolonged work out, whereas others such as specialist units at banks are better equipped to do this.

Many houses do not have resources or the structure to segregate the day-to-day management of portfolio companies, with the investment director who wrote the deal having ongoing responsibility for managing the investment whilst also responsible for new deal origination, execution and exits. As such, the significant time commitment often required in working out distressed or turnaround situations on existing investments can be seen as disproportionate to the return that can be generated, particularly when compared to focusing on a new transaction or successful sale or IPO.

A key factor in securing any investment of resource in such situations, whether time or money, is demonstrating the value which can realistically be recovered or created versus the cost – both cash and opportunity. Accordingly some houses will take a portfolio approach, recognizing that a certain proportion will fall by the wayside and that this will be more than balanced out by focusing on the successful businesses, and this is where time and effort should therefore be directed.

An interesting statistic reported earlier this year by Centre For Management Buy-outs (CMBOR) for the UK, which arguably has one of the most vibrant private equity markets, is that almost 50 per cent of all exits by investee companies in the UK in 2003 were via insolvency. Whilst the vast majority of these failures were on investments where the original deal value was under GBP 10 million, this stark statistic does lend credence to this perception of the industry's 'hands off' approach.

Where action is taken, traditionally the approach of many private equity houses to under-performing companies is to look to change or bolster the management team. Management performance or lack thereof is one of the most frequently cited causes for company failures and a number of houses operate panels, both formal and informal, of executive and non-executive directors, some of whom have turnaround experience. This has worked in many situations and is often seen by other financial stakeholders as a constructive move, which the private equity house as a shareholder may be best placed to engineer.

However, as competition for deals increases and traditional exit routes remain relatively closed, investors into private equity funds, whilst keen to pump in more cash, are looking for greater transparency on whole fund performance. It is becoming an increasingly key differentiator for houses to be able to demonstrate the 'added value' that they bring at a management and operational level. As such, this relatively hands-off approach, even where value may seem to be dissipating rapidly or even have gone completely, is coming under scrutiny.

This is part of the recognition that the old 'buy-sit-sell' financial arbitrage model of the late 90s, where houses seemed able to do relatively little to achieve significant return in a relatively short time frame, has had its day. Whilst there have been some notable exceptions, on average businesses are now being held in portfolios for considerably longer. Another telling finding in the CMBOR report is that the average holding period for investee companies in the UK has almost doubled in 8 years, increasing from $3\frac{1}{2}$ years in 1995 to 5 years in 2002 and just less than 6 years in 2003. Given this length of hold, and that this may not have been envisaged by many of the stakeholders (including management) when the deal was written, the probability of having to manage the business through some performance, stakeholder or funding

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issues has increased significantly, further testing the approach of leaving it to management.

Our view is that 'constructive interference' will be key if private equity is going to address the issue of investor expectation, as well as adapt to the changing market to add, protect and recover value across a portfolio as a whole, including underperforming or more distressed situations. Private equity houses recognize in going into a deal that they have to add something to the business through transformation. The key to success in nearly all cases is building the business and driving growth, which encompasses rigorous management, operational discipline and change processes, which can reduce overheads and fundamentally rethink products and positioning. It is this discipline and thinking that we believe needs to start being brought to bear when times change for the worse.

Many houses argue that this is exactly what they do, and we have certainly worked with a number who are active in this regards and we have seen an increasing tendency to address this; however another recent survey of management teams in private equity backed businesses by Mergermarket, the mergers and acquisitions research agency, casts doubt on just how widespread and established this approach of constructive interference really is. With the survey finding nearly half of British private equity-backed companies with annual sales of between GBP 20 million and GBP 500 million describing their owners as either 'inactive' or 'relatively inactive'.

In contrast to this impression of 'absentee parenting' by mainstream private equity houses, particularly in the world of the more stressed or distressed companies on which we are focusing, there are the new kids on the block – or at least new for Europe. Following on from the distressed US bond holder groups, we are now seeing more specialist distressed US 'private equity' businesses targeting underperforming corporates in the UK and mainland Europe.

The theme of US houses crossing the Atlantic is not new to the European private equity market and it is recognized that they will play an increasingly important role going forward. However, unlike the more mainstream American houses arriving on these shores, these players are actively looking to buy in to underperforming or distressed businesses.

Popular perception around such investors is to see them as 'vulture funds' looking to pick over the carcass for a juicy morsel or two! However this is to an extent an oversimplification and does not reflect the sophistication of many of these operators, or that the market for this type of fund is well established and very much part of the mainstream in the US. In many cases these funds are not out just to make a quick turn by selling on at a small margin, but rather are looking to buy in with a view to gaining control, driving a turnaround and growing value.

Their operations are often relatively small in terms of headcount but have access to significant funds, with focus on detailed research to identify and assess potential opportunities. Not only in terms of turnaround and value creation, but critically to understand the various layers of debt and funding structure, associated rights and security etc. (sometimes better than some of the incumbents) in order to assess how best to buy in and get a seat at the table to exercise influence or control. In this respect they may buy in at a number of levels, both above and below where the 'value breaks', as a means of achieving the end game of equity ownership.

In terms of attitude they can be a key agitator for change, bringing the often key but missing ingredient of 'new money', as well as on occasion orchestrating a merger with another compatible business in which they may also have investment – a situation where combining two underperforming companies does not just create one larger underperformer.

As one restructuring professional described them to me recently, 'they bring energy, a lot of experience, support to management and cash ...': a pretty powerful combination and very much focused on interfering – as they would see it – constructively.

This gives two very different approaches by the industry to troubled businesses, but as the 'new kids' seek to demonstrate the value to be created out of investing into distress, investors in the more 'traditional' players will be increasingly challenging their performance in tackling these more difficult situations. Taken together with the increasing focus on the rescue culture and, in the UK, the introduction of the Enterprise Act, bringing its single overarching purpose focusing first on a rescue of the legal entity and the concept of 'no unnecessary harm' to any stakeholder, we believe that over time the private equity industry will increasingly focus on 'constructive interference' and begin to change some of our industry's perceptions.

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