Private Equity Director

Corbett Keeling
CMS Cameron McKenna
Kleinwort Benson

The Newsletter for Executive Directors of Private Equity Backed Businesses October 2011

Dear Reader,

Welcome to the October 2011 issue of Private Equity Director, the quarterly newsletter for executive directors of private equity backed businesses. PE Director™ covers financial, legal, tax, wealth management and similar issues that are crucial to building and realising the value of your business.

In our last issue, Jeremy Beckwith, Chief Investment Officer of Kleinwort Benson, forecast further trouble to come for Greece, and he wasn't wrong there. Since then, politicians' dithering has led to concerns about a return to recession for some developed economies. Coming so soon after the deep recession of 2008-09, that would clearly cast a pall over the whole world economy, including the private equity industry.

However, we at PE Director are by nature of an optimistic disposition and inclined to trust in the acumen, hard work and resourcefulness of our colleagues within the world of private equity. And we note some positive signs, such as the liquidity being provided by the major central banks and the recent proposal of credit easing by the Chancellor of the Exchequer. These measures should go some way to allaying concerns about funding for businesses, which in turn should be positive for directors of private equity backed businesses looking to grow or sell their companies.

In this edition of PE Director, we look at some of the current topics which we hope will be of interest to you:

- After a disappointing decade for stock market returns, we assess the traditional buy and hold strategy for investing and find that **a more active approach to risk management can help to protect your hard-earned wealth (pages 2 to 3).**
- After a dire first half of the year for deal completions, **the third quarter saw something of a rebound in deal activity, though only for smaller buy-outs.** We also detect signs of a resurgence in one-on-one approaches from potential buyers **(pages 4 to 5).**
- With a vast amount of debt falling due for repayment over the next couple of years, we look at how the environment for private equity backed companies has evolved recently – and offer **some practical tips for directors contemplating a sale, refinancing or restructuring (pages 6 to 8).**

I trust that you will find these articles of interest. If you have any suggestions for topics you wish to see covered in future issues, please contact me at: meganpeel@pedirector.com

Megan Peel, *Editor*

Managing risk and delivering returns in volatile markets

After the bear markets caused by the dot-com bust and the credit crisis, stock markets have been pretty much flat over the past decade, leaving investors with little to show for a nerve-racking roller-coaster ride. Nevertheless, the "buy and hold" approach to equity investing remains the dominant model in the industry. Scott Gray, Head of Fund Management at Kleinwort Benson, asks whether it should be consigned to history as a one-size-fits-all investment strategy, along with its commercial counterpart, the long-only fund. Instead, he calls for a more active approach by wealth managers – and that may be of interest to anyone contemplating an imminent liquidity event.

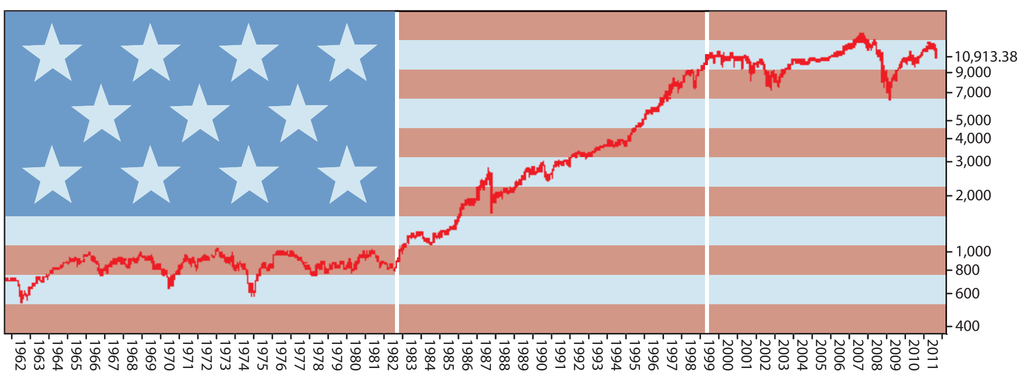
One of the central tenets of investment management has long been "buy and hold". For long-term investors, you buy some good stocks and keep hold of them for a number of years, and you won't go far wrong. That approach does pay off sometimes, but it can also fail to deliver for long stretches of time. By way of illustration, if we look at the Dow Jones Industrial Average (30 of the largest US stocks), buy and hold has proved a valid strategy in just 17 of the last 50 years. Between the ends of 1982 and 1999, investors who reinvested their dividends enjoyed an increase of 18.7% per annum, with one major crash, in 1987. Even those who spent their dividends obtained an annualised return of 15.1%. The rest of the time, buy and hold didn't work so well. Between 1961 and 1982, markets proved volatile and made little progress. The market has also failed to deliver in more recent times, delivering broadly flat returns between 1999 and 2011 but with even greater volatility *(see chart below)*.

Buy and hold has proved a valid strategy in just 17 of the last 50 years

As a strategy, buy and hold is entirely dependent on the point at which you buy the assets and when you need to access funds. In its proper context, it is a valid strategy among a host of other valid strategies, but it is no more than that. Rather, long-only should be seen as a special restricted case of the ordinary activities of fund managers where clients expect close to market returns, no more and no less. This is in fact a highly passive approach, with limited scope for risk or return management. Clients are implicitly asked to take one bet: that markets will go up. This fosters a lack of accountability in the relationship between fund manager and client.

After the tech bust, a number of wealth managers correctly perceived the risk to good client relationships from poor performance. Not surprisingly, few clients were happy with the excuse often heard from managers that "the

Dow Jones Industrial Average October 1961 to September 2011



Last: 10,913.38 | High on 31/10/07: 14,198.10 | Average: 4,142.06 | Low on 29/06/62: 535.76

market was down 30% but we outperformed and only lost you 28%." So, in the new millennium, a subset of wealth managers set out with a strategy for managing client risk. Unfortunately, the responsibility for risk management was outsourced and effectively abdicated to external fund managers. With no way of correctly assessing their risk exposures, a number of wealth managers were confronted with blow-ups, serious fraud and restrictions on withdrawing money from funds which resulted in a severe liquidity mismatch between the underlying investments and the expectations of their clients.

Wealth managers need to develop the skills to manage performance effectively

The logical conclusion of the market environment since the second quarter of 2007 is that wealth managers need to develop the skills to manage performance effectively. At Kleinwort Benson, we believe that, in a highly indebted world, investment returns are set to become more, not less, volatile in the medium term. Hence, this skill set will become increasingly valuable to clients. While there are many attractive opportunities on the global landscape, the judicious management of risk is central to any successful investment approach.

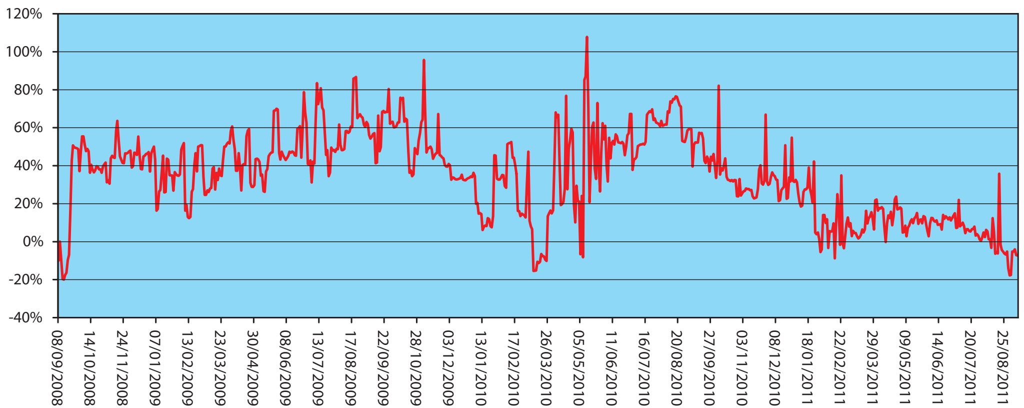
In our opinion, the cornerstone of any investment process that seeks to manage risk and return over a market cycle should be a considered worldview encompassing the dynamics of deleveraging combined with a robust understanding of cyclical patterns. The investment instruments employed to capture return or manage risk need to be highly liquid, with little friction. Fund managers will need to demonstrate the ability and conviction to adjust their risk exposures substantially, depending on market circumstances. Investors remain nervous and yet regret the forgone returns of the last two years. We think it is increasingly important that wealth managers assume responsibility for market risk. Certainly, this is a responsibility we accept at Kleinwort Benson. By way of illustration, the chart below shows how we have controlled net exposure to equity markets over the last three years in our investment programme.

The exposure has varied considerably, from 20% short (which would earn a 2% increase in the portfolio for a 10% fall in markets) to 110% long (an 11% increase for a 10% rise in markets).

Against a backdrop of continuing low interest rates, flat equity markets and higher taxation, we are finding that clients are increasingly demanding risk management at the core of their portfolios. Together with greater transparency and independent risk management controls, independent compliance and administration, a risk-managed solution should be at the heart of effective wealth management. The buy and hold strategy, and long-only funds, can work – but only for some of the time.

E-mail: Scott.Gray@kleinwortbenson.com

Kleinwort Benson's Daily Net Equity Exposure, September 2008 to September 2011



This note is intended to give an insight into the thought processes that lie behind our investment views and our investment strategy. They do not necessarily reflect the current investment policy of Kleinwort Benson. This note is intended for information purposes only and does not take into account the investment objective, the financial situation, or the individual needs of any particular person. Investors should obtain independent advice based on their own particular circumstances before making investment decisions.

A mixed quarter

The first half of the year was difficult for the private equity world. So, with financial markets reeling from the political paralysis in the eurozone and the US, could private equity buck the trend and register a reasonable third quarter? Here, Jim Keeling of corporate finance advisor Corbett Keeling looks at the data and declares the result mixed, but he also detects some interesting changes in the deal-making environment which may afford opportunities for the more nimble players.

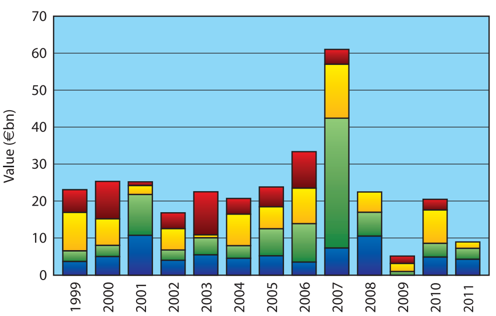
The press is awash with scare stories about a renewed, or some would simply say continued, financial crisis. But what has actually been happening by way of UK private equity investment activity? And, in these uncertain times, what do market participants think will happen in the coming months? We will try to find some answers to these questions by reviewing the preliminary data produced by private equity journal Unquote for the third quarter of 2011.

The press is awash with scare stories about a renewed, or some would simply say continued, financial crisis

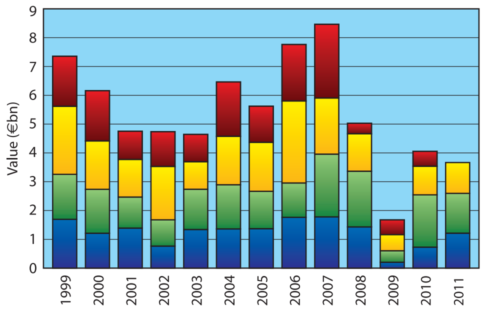
We start with the historic facts for numbers and values of larger UK buy-outs of more than €150 million enterprise value, then UK buy-outs of less than €150 million and finally early stage and expansion capital deals.

- At the time of writing, only three **larger UK buy-outs** (€150 million or above) had been reported as completed in the third quarter of 2011. Together, they had a total value of €1.7 billion. Of course, one or two additional deals may be reported late. That said, the only period with a worse result was the nadir in deal-making at the end of 2008 and the beginning of 2009. The picture is more encouraging for the year to date, as the first two quarters were stronger. However, in the light of the current global financial situation, it probably makes more sense to put greater emphasis on the most recent period.

- For **smaller UK buy-outs** (below €150 million), it's a considerably more uplifting story. Whether you look at the statistics for the *most recent quarter* or the *year to date*, they are a good match for most of the comparative 12 years (even if, not surprisingly, they are some way off the heyday years of 1999-2000 and 2006-07). The preliminary result for the quarter is 25 deals for an aggregate of slightly over €1 billion.

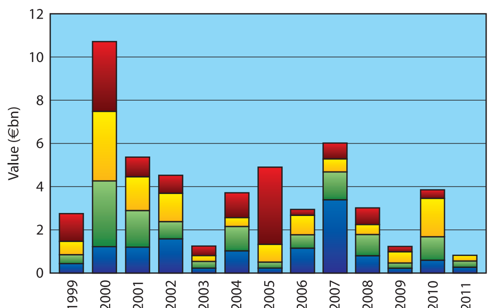


Sub €150m Buy-outs by Value



- Unfortunately, **UK early stage and expansion capital deals** take after their larger buy-out cousins. The picture is of weak activity, signalling investors' unwillingness either to take risks backing younger businesses or to put fresh money (development capital) behind existing companies. Just 22 transactions have been reported so far this period – a quarterly record low since Unquote's statistics start. And the aggregate investment, at €256 million, was itself not far off the low for all recorded periods.

Early-Stage/Expansion Deals by Value



- Against this back-drop, the proportion of *all equity deals* to *all deals* has levelled out at around 20%. This is maybe not surprising given it had already come down significantly from a peak of 45% in early 2009.

So the picture painted by the historic data is mixed, with the mid-market holding up, helped by a constant supply of gearing, while larger and venture or development capital deals perform weakly. Unquote's survey of market participants also gives mixed signals:

- A large proportion of respondents expect smaller deal activity to remain at recent levels, supported by an adequate supply of bank debt. However, larger deal activity is expected to decline – even from its current low levels.

Respondents are, perhaps surprisingly, recruiting to build their teams

- Against this backdrop, respondents are, perhaps surprisingly, recruiting to build their teams. Less surprisingly, they believe that higher inflation and the eurozone crisis are having a negative impact.

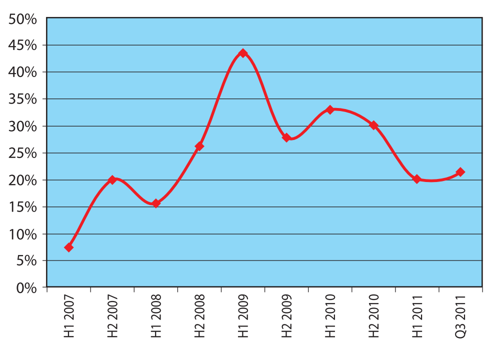
Our regular readers will be pleased to know that we have not changed our tune!

What conclusions can we draw, then? In our last quarterly review, we said all mergers and acquisitions activity is highly cyclical, so the current downswing should be expected to lead to a strong upswing. Our regular readers will be pleased to know that we have not changed our tune!

Owners are more receptive to one-on-one approaches from buyers with the funds

What we are seeing, both in recently completed deals and in the pipeline at our own firm, is the market adapting to the new reality: owners remain nervous of putting their heads above the parapet by starting a sale process; but, as they sense this may remain the case for a while, they are more receptive to one-on-one approaches from buyers. And those buyers with the funds – including many private equity groups – are sensing the same and are consequently more inclined to initiate one-on-one sale processes. Where buyers do this, they find that sellers are far more prepared to go along with them than in the past, when they might have immediately put their business up for auction. For our part, we have seen many more of these sorts of one-on-one processes in the last few months than in previous years.

All Equity Funded Buy-outs to *All* Buy-outs



So we remain optimistic. As ever, deal-makers will have to adapt, maybe focusing more on the mid-market and being prepared to do deals out of auctions. But, for the fleet of foot, there should be plenty of activity.

E-mail: Jim.Keeling@corbettkeeling.com

This is an edited version of an article published in the private equity journal unquote". Statistics are provided by unquote" and Incisive Financial Publishing.

Another brick in the wall?

As if directors of private equity backed companies didn't have enough to deal with at present, they are also facing an impending "wall of debt" – the affectionate term given to the vast amount of debt that needs to be repaid, refinanced or otherwise restructured over the next couple of years. Here, Dipesh Santilale of law firm CMS Cameron McKenna assesses the new environment and offers some practical suggestions for directors whose current borrowing arrangements are coming to an end.

Although it is hard to quantify the precise scale of the wall of debt that is falling due imminently for businesses around the world, estimates range from £200 billion up to as much as £500 billion, and a significant chunk of that relates to acquisition finance debt extended during the credit boom that ended in 2008.

Moreover, non-investment-grade facilities are often secured against the borrowers' assets and can contain a number of tranches of debt which are provided for specific purposes, such as acquisitions, working capital and other trade-related facilities. So this is not just an issue for the PE sponsors, lenders or other investment funds and their respective exposures; it is also a concern for current and potential borrowers and investees.

The macro-economic climate is unlikely to get better any time soon

Recently, there have been some high-profile business failures within the leisure, healthcare, manufacturing and retail sectors. Although the underlying economic climate and consumer nervousness have contributed to their problems, it is ultimately the firms with highly leveraged balance sheets that are most sensitive to macro-economic changes. Unfortunately, the macro-economic climate is unlikely to get better any time soon, what with the crisis in the eurozone, banks' exposure to sovereign debt and the volatility of capital markets.

Not surprisingly, investors' and lenders' views and market practices have therefore become more risk-averse and, for the most part, stricter than in previous years.

A new landscape

The environment has changed materially, in a number of different ways.

- PE investors are more alive to potential restructuring issues, many having been burnt on recent restructuring deals. It is now not uncommon to see more comprehensive information and audit rights, along with earlier "step in" rights for the investor where defaults occur or, more commonly, are looming. In many cases, the triggers for these rights when a business is underperforming are being set much earlier than before.
- A number of investors are now reviewing the terms of management's equity investment in the context of a possible restructuring. As a result, these terms are now inclining more towards "sweat" than "sweet".

Structures are being designed to ensure that management teams are still motivated by more "sweat" than "sweet"

- Equity values and potential equity returns for many PE backed businesses are now lower than expected or, indeed, desired. Hence, a number of capital restructurings and alternative management incentive arrangements are being required. As well as re-organising the structure of the lenders' and investors' debt and capital interests, where there is no tangible ordinary equity incentive, the structures are being designed to ensure that existing or new management teams are still motivated to grow the aggregate enterprise value of the business so as to secure maximum recovery for lenders and investors.
- Some of the lending terms and packages that were available before the credit crunch can no longer generally be obtained on favourable terms. A bank providing new lending will be very focused on the downside risks and on ensuring that returns are adequate to justify the risk profile of the business. This has led some banks to consider more creative approaches to pricing and taking upside in businesses. These may include charging additional fees and entering into property participation or equity arrangements.
- Leverage ratios are in many cases lower than previously offered by banks. Financial covenants and restrictions on business

activities are often stricter and, as with PE investors, there is a greater emphasis on the downside risks and more concern over how the different layers of debt will be affected (and hence the commercial and negotiating position of each class of lender or investor) on any restructuring or insolvency.

- Lenders are also reducing their exposure to or responsibility for other financial institutions within a syndicate, given the concerns about the stability of many firms in the financial sector. This has led to more complex so-called club deals, where borrowers face negotiating with several lenders, instead of one which would "front" the commitments and facilities for the whole syndicate, in respect of both the initial negotiations and the subsequent management of the facilities and relationship between the lenders and borrower.
- There is far more scrutiny from the investment and credit committees of lenders, and due diligence is more rigorous and takes longer than a few years ago. Though an inevitable consequence of the current climate, this leads to a lot of stop-start processes which can be frustrating, or even fatal, for businesses seeking to refinance or take in new investment.

Competition among lenders and investors is fierce

Nevertheless, for strong borrowers or investment opportunities, the competition among lenders and investors is fierce, given their need to earn a return on their capital and the relatively limited supply of opportunities. For investment-grade companies, a number of recent deals have been concluded with the sorts of auction processes we became used to before the credit crunch.

Some practical tips

Now, that may sound like a fairly scary list of concerns for directors either seeking new investment or preparing for a refinancing for, or exit from, their current arrangements. So how can they give themselves the best chance of avoiding a collision with the wall of debt and unblocking the road ahead for growth of their businesses?

Ensure your own house is in order. Though important at any time, it is crucial in this climate for directors to have a thorough, up-to-date view of the business's finances and cash flow. Lenders and PE investors are becoming increasingly nervous of businesses where financial and management information is either unreliable or not available. This nearly always causes a serious problem when the various parties are attempting to discuss and review a potential financing or restructuring.

Besides, if such information is not regularly and rigorously reviewed and analysed, directors may miss opportunities for optimising cash flows, reducing wasted expenditure or indeed securing better investment or lending terms when the time comes.

As part of this process, it is advisable to carry out a health check of your current finance arrangements and terms so that you know where you stand when starting discussions with investors or lenders.

Don't miss deadlines. Recent evidence from Companies House and from our banking and PE clients suggests that many UK businesses are struggling to file their accounts on time and submit financial and management information to the lenders and investors in accordance with the various agreements or previous practice. This can have serious consequences for trading activities and access to finance, triggering defaults or enabling lenders to withdraw committed facilities or overdrafts. Missing or late statutory accounts also flag concerns to trade suppliers and credit insurance underwriters, and withdrawal of key supplies or credit insurance have been key factors in some recent corporate failures.

Directors and auditors are increasingly concerned about their liabilities when signing off accounts on a "going concern" basis, especially where a business needs further funding or has to refinance debt in the near future. Hence, discussions with auditors must begin early enough for any such issues to be addressed in good time before the relevant filing deadlines.

Assess your options early. Directors are understandably nervous about when to start discussions with lenders and investors, particularly where the business may be underperforming or missing budgets or forecasts. However, it is crucial to take advice and consider the options early. Directors negotiating with their backs to the wall because of an actual or imminent covenant breach are unlikely to be able to conclude the most favourable deal.

Continued on page 8

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Furthermore, if the investment or refinancing is planned early enough, there may be alternative sources and forms of capital or finance available, such as asset backed lending. For certain types of businesses, these may be more suitable than traditional sources of funding.

In assessing these options and the financial position of the business, these issues should be discussed regularly at board meetings, but it is important to keep records of these discussions as this will reduce the risk of personal liability if the business does fail. Early professional advice can also help in this regard; it can provide solutions that directors – who are working all hours to protect and run the business – may be too busy to consider, let alone execute.

E-mail: Dipesh.Santilale@cms-cmck.com

Contributors to Private Equity Director:

Corbett Keeling

13 St Swithin's Lane
London EC4N 8AL

Telephone: +44 (0)20 7626 6266
Fax: +44 (0)20 7626 7005

www.corbettkeeling.com

Corbett Keeling is a corporate finance advisory firm focused on:

- Raising funds for management teams to do buy-outs.
- Selling businesses.

Contact: Jim Keeling
Joint Chairman
E-mail: Jim.Keeling@corbettkeeling.com

CMS Cameron McKenna LLP

Mitre House, 160 Aldersgate Street
London EC1A 4DD

Telephone: +44 (0)20 7367 3000
Fax: +44 (0)20 7367 2000

www.cms-cmck.com

CMS Cameron McKenna LLP is the UK-headquartered member of CMS, the leading European provider of legal and tax services.

Contact: Richard Bull
Partner, Private Equity Group
E-mail: Richard.Bull@cms-cmck.com

Kleinwort Benson

30 Gresham Street
London EC2V 7PG

Telephone: +44 (0)20 3207 7000
Fax: +44 (0)20 3207 7001

www.kleinwortbenson.com

Kleinwort Benson has over 200 years' experience in British banking and a network of offices across the UK and Channel Islands. It offers its clients individually tailored wealth management solutions delivered with a highly personal service.

Contact: Ben Whitworth
Head of Entrepreneurs
& Senior Executives
E-mail: Ben.Whitworth@
kleinwortbenson.com

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