



## Impact of the current crisis on Small & Mid-market Buy-outs and Special Situations: the views of Access' GPs

*On October 30<sup>th</sup> 2008, Access Capital Partners held its 8th Annual General Partners Meeting and gathered 38 of its small to mid-market buy-out and special situations GPs to exchange views on the current financial crisis.*

*Whereas all the GPs agreed on the difficulties the industry will inevitably be facing over the next few years, the discussion focused on measures to smoothen the impact of the downturn on portfolio companies and on new opportunities arising in the current market context.*

### Cloudy outlook for 2009

GPs unanimously expressed concerns over the general economic outlook, expecting that the most difficult times were still to come. What started as a financial turmoil has led to a total collapse of the global credit system and the crisis is spreading fast to the real economy.

*"We are at the end of the 30 year credit expansion period."*

Considered way more significant than 2001-2003, the current downturn can rather be compared to the 1993 crisis. As a consequence, none of the GPs expect a recovery before at least 2 to 3 years.

This is posing a serious challenge for existing portfolio companies, which will eventually be affected by reduced consumer and business spending.

*"The financial crisis is now starting to hit the real economy. None of our portfolio companies has yet experienced a real downturn, but every company already shows some impact."*

### How can GPs steer their existing portfolio companies out of trouble?

#### Be proactive about leverage and the relationships with banks

Over the next few months, portfolio companies will most probably experience delayed receivables, reduced earnings and stricter credit conditions. Businesses will need more working capital to continue growing, and this will become harder to find.

*"Banks are trying to reduce their risk and asking us if they can for example cut down on the revolving credit lines. Banks are now becoming the defaulting party of an LBO."*

GPs agreed that one of the key elements of securing the financial health of their portfolio companies was to be proactive about the bank relationship and potential leverage issues.

*"Anticipating any debt-related issues and talking to the banks about it early is vital."*

Many GPs perceive a readiness for dialogue on the banks' side.

*"Banks also understand that it is not in their interest to panic, they do not really want to end up owning all the companies they are financing because the equity sponsor has walked away from the deal."*



Several funds are now using their cash to deleverage their companies and re-inject equity or equity-like instruments, such as convertible bonds, in order to reduce the risk of covenant breach.

*"In our fund, we have developed a worst-case scenario for each company and then we figure out how we will be able to finance the company through such a scenario."*

### **Work the assets harder, intensify operational support, manage cash**

GPs are now rolling up their sleeves, exploiting their portfolio companies' assets even more in order to release liquidity (for instance by sale-and-lease-back of real estate).

Operational support is becoming even more intense, with a stronger implication of operational partners and, above all, increased cost control. A crucial role will be played by the underlying companies' CFOs who need to optimise cash by monitoring very closely receivables and payables.

*"We consistently have to work our assets harder; that will be the basis for outperformance in the years to come. It pays for instance to look at non-core assets to sell off."*

For many GPs, consolidation will also be a means to strengthen companies, helping them to achieve critical size, and therefore, to resist the economic turmoil better.

Add-on acquisitions are expected to come at more attractive prices than in the past, and offer a possibility to restructure the debt on the new entity.

Constituting sufficient cash reserves is another point GPs are strongly focusing on in the current context. They are carefully managing the cash in their funds in order to be able to reinforce portfolio companies if they require additional financing.

### **...and if necessary, change the management**

GPs believe that one of their key tasks will be to coach the underlying management and prepare them for all eventualities. GPs are currently, together with the management teams, revising budgets and forecasts and developing a Plan B for the worst-case scenario. Nevertheless, for those teams who will ultimately not be up to the task, action will have to be taken.

*"Another important question we will have to ask ourselves for some portfolio companies is whether the current management is strong enough to weather the storm. It will be a challenge for most, especially those who have only known the good years of economic growth. Some replacements in management will be inevitable."*

### **Great opportunities lie ahead**

#### **Buying opportunities with prices coming down to attractive levels**

Deal flow remains strong and is expected to increase even further, fuelled in particular by distressed sellers (indebted large corporations, underperforming GPs).

With a lack of growth looming ahead, buying cheap and buying well - one of the key criteria Access has traditionally been applying to the selection of its GPs - will return as the fundamental principles.

The GPs have however not yet witnessed a decrease in price, as sellers still cling on to valuation levels from the recent boom times. GPs therefore predict a period of several months of very low deal making activity and a pick-up, probably around Q3 2009, once sellers have adjusted their price expectations.

*"Although I am gloomy on the general economic outlook, the current climate obviously presents attractive business opportunities. One of the*



*positive outcomes will be more reasonable pricing."*

### **Flight to quality**

Increased prudence by GPs about the assets they buy will lead to a flight to quality. In order to be eligible for investment, companies will have to stand out from the crowd even more than before, as real market leaders with outstanding managers able to navigate in bad and good times.

Time spent on due diligence by GPs is expected to increase, with extra work on cost of money issues and on model testing.

Even though cash flow aspects will remain major when buying a business, the existence of sellable assets (such as real estate) will also be key in the short-term.

*"We have become more prudent on the value of the underlying assets and are increasing the time and effort to identify best-in-class companies. We will equally be very cautious about sectors we consider too much at risk, such as consumer goods, construction or the automotive segment."*

### **Deal structuring: GPs are getting more innovative and move away from classic debt**

In the tightening debt market, GPs are preparing for deal structures which will involve less classic bank debt, and are developing other possibilities instead. As has been the case already for some of the deals completed by Access' GPs in the recent months, equity ratios will go up and some deals will only be financed with mezzanine debt or without any debt at all.

GPs will also be looking increasingly at other instruments such as convertible bonds or vendor loans, and are planning to introduce some leverage further down the road once debt conditions have gotten more attractive again.

### **Turnarounds: weaker impact of the credit crunch & stronger deal flow**

Turnaround players should see only a moderate impact of the debt shortage since their transactions typically display low leverage ratios or even no debt at all. Additionally, the increased financial distress many businesses are today finding themselves in is expected to lead to a stronger deal flow for turnaround players. Nevertheless, these GPs are aware that they must continue watching out for quality and privilege A+ assets above pure bargains.

### **Conclusion**

Portfolio companies, particularly from vintages 2006-2007, will undoubtedly be facing hard times due to economic slowdown, debt burden and delayed exits. Even more hard work will have to be applied and this over longer periods of time due to the extension of holding periods.

Portfolio valuations are expected to suffer further in the medium term, following the fall in comparables and operational difficulties.

As a result, the market is preparing for a selection process in the buy-out segment, leading inevitably to the failure of underperforming GPs over the next years.

Although some of its GPs may fail to deliver the expected returns, Access remains confident in the ability of most of its GPs to steer through the turmoil and protect their existing portfolio while grasping new opportunities arising from the crisis.

There should even be an increased return premium in these times of debt shortage for the Access' investment philosophy which traditionally favors GPs who support growth with hands-on management instead of merely relying on financial engineering.



The paradox of the Private Equity industry has always been that it is hard to raise money when it is actually a good time to buy, and, inversely, very easy to raise funds when the market is at its peak. Access and most of its GPs have witnessed various cycles in this industry and the history shows that the best investments have been made in recession years.

Access therefore sees no need for small to mid-market private equity to reinvent itself as the basic ingredients of future returns in this segment (disciplined pricing, moderate leverage, high quality management teams, hands on involvement) will not vary.

Good quality businesses will continue to attract buy-out activity, so as we look ahead, Private Equity still stands a good chance to continue outperforming other asset classes as it has been doing in the past.