



Have we reached the bottom of the crisis?

Access GPs' market views

On October 15th 2009, Access Capital Partners held its 9th Annual General Partners Meeting and gathered 41 of its small to mid-market buy-out and special situations GPs to exchange views on the current state of the market.

Whereas almost all the GPs agreed that they were currently going through challenging times steering their portfolios through the trouble, the discussion showed that most participants already feel that the market is stabilising and potentially on its way to recovery.

Where are the existing portfolios heading?

Since last year's meeting, the financial crisis has strongly impacted the real economy. Every GP backed by Access is now seeing one or more companies in his portfolio suffering from reduced consumer and business spending, despite the precautionary measures they had been taking in anticipation of the crisis. In this context, several GPs have faced and continue to face breaches of covenants by at least one of their portfolio companies.

Cash reserves have proven useful

The prudent cash management of Access' GPs, in order to be able to reinforce portfolio companies if they require additional capital injections, has proven wise: more than half of GPs have done at least one equity cure over the past 12 months in order to prevent or remedy a covenant breach.

Longer holding periods...

On the exit side, most GPs expect their average holding period (historically 2.8 years for deals exited over last 3 years in the overall Access portfolio) to increase by another 1 to 1.5 years on average, therefore reaching 4 to 4.5 years.

... but exit markets are seen to be coming back

Alongside the stabilisation and the promises of a general economic recovery, IPO markets are gradually making their comeback. GPs agreed that on the back of the public markets' recovery, the mid-market will be able to seize some good exit opportunities through IPOs. It is further anticipated that the current capital overhang in the large buy-out segment, coming from the strong fundraising years these funds have enjoyed until the crisis struck, will eventually find its way to the mid-market companies and allow for successful exits (this is expected to apply particularly to the upper end of Access' deal size spectrum):

"The mid-market usually takes the last wagon of a bigger train: IPO markets are coming back, and there is a huge amount of large cap money around. All this will find its way into our segment and provide for good exits in the medium term."

Leverage and bank relationships

Strongly linked to the current state of the portfolio is the debt situation of portfolio companies and the GPs' relationships with the lending banks.



Already one of the key issues of last year's meeting, this aspect has remained a central point on every GP's agenda: over the last two years, addressing banks proactively about potential leverage issues has proven crucial to securing the financial health of portfolio companies.

Banks have become more aggressive...

Most GPs have found that many banks have recently hardened their stance towards companies not fulfilling their covenants. Further, some GPs believe that more covenant breaches are to come, with unemployment on the rise and a resulting big drop in consumer spending. Particularly for deals where large banking syndicates are involved (although this is a lot less common in the mid-market than in very large transactions), GPs perceive a higher degree of risk for the company:

"Frequently, the only consensus which can be reached by a very large syndicate is to send the company into bankruptcy. The smaller the syndicate, the easier it is to reach alternative agreements."

The picture also seems to vary, although to a lesser extent, according to geography: UK and Nordic banks seem to be more prepared than their remaining European counterparts to step in and take control.

... but negotiations remain possible

Despite the pessimism voiced by some GPs as to the current attitude of banks, participants agreed that this has to be put against a broader picture - which is that small to mid-market players are not on the top of the banks' lists of priorities. Banks have only a limited amount of attention to dedicate to their small and mid-market debtors and - a point already raised last year and which still holds true - most banks simply cannot and do not want to become owners of a load of defaulting SMEs, taking even more of their already scarce time. In this context, most GPs perceived their own negotiating position as reasonable:

"The banks we deal with have been in a state of chaos for several months, short of profits and getting tougher with us PE guys. However, they remain reluctant to step in because they are simply too swamped to cope. They have far bigger problems."

A look at the Access portfolio supports the case: half of all breaches of covenant in the Access portfolio have already been subject to a waiver by the banks, in exchange for the reinjection of limited additional equity by the GP (at a moderate average level of around 15% of the existing equity ticket) and/or a restructuring of the covenant agreement.

New threats from distressed debt investors

However, several GPs have been perceiving for a while another debt-related threat, coming from the distressed debt segment - increasingly populated by larger buy-out players following an opportunistic distressed debt strategy. Some firms cheaply acquire debt positions from banks in companies which are facing covenant problems and then wipe out the sponsor's equity by forcing the company into bankruptcy.

"We increasingly see large cap houses biting into mid-market players' equity."

Unanimously, the GPs believed that the best antidote against such an equity wipe-out - which still remains a marginal phenomenon - is to keep up a quality relationship with the bankers in order to avoid bad surprises of this sort.

Make sure to be your bank's favourite GP

It was generally agreed that a GP has to make sure to be on the "A list" of the lending banks. Firms which have been around for some time and have kept up quality relationships with their bankers all along enjoy a definite advantage in this respect. In the current context, a few GPs have even hired banking specialists to help them dialogue with banks and optimise negotiations.



Deal making

With an economic stabilisation if not a recovery now potentially underway, meaning increased visibility on the future performance of target companies, new buyout transactions are back on the agenda. However, there continues to be a reluctance from sellers which, combined with an ongoing scarcity of debt finance, is keeping deal volumes down.

The pricing gap has not yet closed...

The main reason for this is seen in the pricing gap which persists between sellers and buyers. Market statistics suggest that those few deals which still get done do so at entry multiples almost as high as during the recent boom times. It is generally argued in the market that sellers of quality assets are determined to wait for better times and refuse to sell at a discounted price today.

...but Access' GPs pay less than a year ago

The picture in the Access portfolio is different: whereas deal making activity has been clearly down (22 new deals as of Q3 2009 vs. 92 for all 2008), so have prices: 6.1x Ebitda average entry price in 2009 vs 6.9x in 2008, i.e. a decrease by around 12%. In this respect, Access' GPs have been able better than the overall market to take advantage of the current climate and identify quality assets at reasonable prices, usually by keeping out of auctions - rare anyway in the current context - and privileging deal sources such as distressed sellers or other challenging situations like e.g. shareholder disputes. As one of the GPs pointed out:

"Difficult sourcing and long negotiations have always been one of the features of the mid-market. We are used to being pro-active and perseverant; this enables us to keep going in the current environment."

Longer DDs, innovative deal structures

Time spent on due diligence by GPs has increased, particularly with more time spent on model testing:

"Today, we price a far wider array of possible scenarios into our model."

"The difference to 18 months ago is that today, no one believes the business plan figures any more."

Further, as anticipated at last year's meeting, Access' GPs have become less dependent from classic debt and ventured out towards alternative sources of financing: as demonstrated by the evolution in the Access portfolio, average equity ratios have gone up and GPs have increasingly made use of other financing instruments such as convertible bonds or vendor loans.

Most GPs, however, keep at the back of their minds the option to introduce some leverage further down the road in deals with low or no leverage once debt conditions have become more attractive again. In this context, Access made its own point of view very clear, being that the GPs should be prudent in this respect and only bite off as much as they can chew: no GP should write a big equity check for a transaction and find himself, if eventually unable to refinance, with too big an exposure on one single transaction.

Lending conditions are set to improve

90% of Access' GPs think that alongside the general economic recovery, lending conditions should improve over the next 12 months:

"Banks will realise that doing business with mid-market houses is actually good and profitable business. First, they have to get their own house in order, but then they'll be back."

GPs however agreed that in the future they will have to bring more to the table: they will have to prove even more to the banks that they have well thought out the deal and are prepared for all possible scenarios.



“We must show that we are ready to solve not only our but also their problems.”

Banks are however expected to look for more control of their own risks and should therefore be less likely to engage in the same syndication frenzy as before:

“The error the banks committed was that they were trying to commoditise Private Equity.”

Conclusion

Since last year's meeting, several portfolios have been suffering further, following the fall in comparables and operational difficulties. But most participants felt that the low point has been reached and that the market is regaining visibility again.

Positive outlook for the medium term

Even if a few GPs painted a relatively cloudy short term picture for the next 6-12 months in terms of portfolio health, deal making and lending conditions, participants agreed on a material improvement of conditions lying ahead for the next 12 to 18 months.

Shake-out during the next fundraising

The bad hit many portfolios have taken across the whole buy-out segment – and from which some of them will not recover – is expected to lead to a wash-out among PE players during the next fundraising cycle. The winners and losers are likely to be determined by the following factors: how many problem cases the GPs have in their portfolios, how much cash they have left to invest and whether they can demonstrate to their investors that their value creation model has been successful and will be sustainable going forward.

Access continues to believe that the crisis we now seem to be gradually emerging from has brought about a healthy back-to-basics evolution to the

entire Private Equity segment by focusing on operational and strategic improvements rather than a “go with the flow” attitude that led to overleverage and increased risk.

The crisis has proven the small and mid-market model right...

By following the market and portfolio statistics closely over the last two years - in terms of deal making, operational evolution of underlying companies and exit activity - Access has found that the small and mid-market in general and Access' GPs in particular have been able to weather the storm better than the rest of the market. This crisis has therefore been another proof for the resilience of Access' core segment.

The vast majority of this year's participants said they would continue sticking to their respective and long-standing strategies and do not see the need to adapt to changing market conditions – since they already feel well equipped to make it through difficult times such as this one.

...but diversification remains key

What however also emerged from the day's discussions was the role which LPs have to play in ensuring that the investment risk be kept down to an acceptable level: whereas it is the GP's business to identify quality companies and conclude attractive deals, LPs should continuously call for the respect of safeguards, particularly as to basic rules such as diversification. Almost any portfolio will take a hit at least once during its lifetime – be it that the fund manager has done a bad deal or that he has overpaid for deals of an expensive vintage. But the impact on performance and the GP's reputation can be greatly limited if basic rules of diversification over time and amount have been respected in the first place.