September – October 2008
Iberian Lawyer Magazine

ABOGADOS
ARAOZ & RUEDA

CREDIT WEIJI: GENUINE CRISIS OR TIME FOR OPPORTUNITY?

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In the late 1950s, JF Kennedy said that "when written in Chinese the word crisis *(wēijī)* is composed of two characters: One represents danger, and the other represents opportunity". Despite the efforts of linguists and writing theorists to clarify that in Mandarin a *wēijī* is indeed a genuine crisis, a dangerous moment, a time when things start to go wary, a critical or crucial point and not an opportunity, since that speech in Indianapolis, this presumed oriental wisdom is erroneously used by many politicians, popular press and financial gurus to communicate the inspirational notion that a crisis should be a time of optimism and a juncture when one goes looking for advantages and benefits.

The managing partner of one of the biggest VC firm recently said that after the *golden age* of the period 2002-mid'2007, the VC industry will now spend a year or so in "purgatory" before entering an even greater period of expansion, or *platinum age*. The discussion underlying this opinion is whether the credit crisis is helping or hurting venture capitalists.

On the positive side, it is a fact that many VC firms have raised billions of euros in new money within the last two years and all that money is ready to be invested in a deflationary environment in which prices are plummeting.

Another positive factor is that VC is a long-term asset class and any changes to the sector will take time to turnaround. In other words, unlike hedge-fund managers, VC capital is locked up for a long period of time.

In addition, VC's origin of funds usually shows a reasonable balance between debt and capital at the corporate level, something that allows these firms to expand into new opportunities while investment banks and other financial players are shrinking or shutting down.

Based on the foregoing, a very optimistic observer would conclude that the present situation is one of the severe adjustments that happens from time to time with no long-lasting effects on the VC industry. However, there are some areas of concern that should be analysed to reach a more realistic approach. I will just refer to two of them, although it would be quite easy to increase the list substantially.

i) Divestments: With an adverse economic environment, past flows of acquisitions will reduce dramatically until the credit market recovers or prices go down. Potential buyers may not obtain the necessary financing or find it is too costly for a target business which value has been calculated with pre-crisis criteria. That means that the

VC's returns may be affected in those cases where the VC needs to divest as the investment cycle comes to an end.

Furthermore, the stock market turmoil, including the evolution of share prices of the eleven companies that went to public on 2007 in Spain, goes in parallel with the evolution of the credit markets and explains the IPO drought for 2008. Although IPOs have been an emerging exit route for VC investments in the last three years, it seems it will take some time before VC players may (generally) benefit from this route again.

ii) Portfolio companies: Many of the big LBOs completed by VC firms in the last four years used heavy leverage. Those target companies having a solid capital structure will have time to ride out the storm but others could be adversely affected by a slowdown in the real economy and the difficulties to maintain their credit lines. On top of that, banks and credit entities will monitor in a more closely and rigorously manner the compliance with solvency and debt covenants and this will imply an extra pressure that may distract management from the day-to-day business and frustrate many built-up projects.

It is true that in spite of the ongoing credit crisis, opportunities for VCs in the financial services sector remain compelling. However, it is time for prudence as most recent experience on the credit crisis shows that a feel-good attitude toward adversity may not be the most rational, realistic approach to its solution.

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