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A RETURN TO BASICS: SURVIVAL OF THE FITTEST

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With the paralysis of the debt markets and the uncertainty about how long and deep the economic downturn will be and with the certainty that all these factors will likely affect business performance, some experts question the ability of private equity houses (PEHs) to do new deals in the current environment.

It is, some would suggest, as if the private equity sector has from a high of mid-2007 returned to the Stone Age, particularly as the ultimate impact of the economic downturn on companies will likely be much worse than predicted even just one and a half years ago.

Certainly, the coming years of recession will make both new investments and exits from investments a more difficult task, not only due to the lack of financing but also because many company valuations are still in line with the high expectations generated just a few months ago.

In this context, we may see over the next few years not only changes in the investment models of PEHs to adapt to the new environment but also a return to fundamentals. But it is also important to remark that the traditional model of private equity has always been built on business fundamentals, and that many of the sector's highest returns have been consistently generated in times of financial turmoil.

The recession will create good opportunities for distressed investors seeking to acquire an interest in troubled companies, with the aim of accomplishing operational and restructuring changes to make them profitable. But assuming an adjustment on the pricing expectations, cost-cutting alone is not a long-term value creation strategy. In this respect, it should be borne in mind that private equity investment cycle is quite long and therefore selection of the target companies - and a proper understanding of the specific market sector by the private equity - will be critical factors to generate value to the investment.

On the other hand, minority investments seemed to have been quite abandoned in the last few years as they do not provide PEHs with full control over the portfolio company. This is clearly useful when dealing with underperformance by the management, or when exiting an investment, and they require more resources and attention to be properly monitored than companies where the PEH holds a majority interest. However, in the current situation, small-size and medium-size companies that are struggling with financing problems may offer great investment opportunities, particularly if they are in positive numbers.

It is a fact that these are difficult times for traditional leveraged buy-out (LBO) transactions. In a very simplistic approach, equity value is created for the PEH by using free cash-flow generated by the business to pay down the acquisition debt.

As I said before, historically, the best buy-out returns come from investments made in a recessionary period. However, the difference between the current environment and past recessionary period is that debt "wells" seem to have totally dried up. The next two years will therefore be critical for many private equity firms, and it is likely that there will be a sort of Darwinian selection that will especially affect those PEHs that completed investments by paying excessive prices because of the availability of cheap and easy debt, and/or those firms whose portfolio is overleveraged.

Nobody really knows where the bottom is, but assuming that sooner or later the debt market will recover some liquidity it seems reasonable to expect that financing providers will then significantly increase their due diligence tests - to concentrate on top performance buyout PEHs with a proven capacity to support and manage their portfolio companies in an efficient manner.

Those who are not generally perceived as leaders in the market may be in serious danger of extinction.

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