



Private Equity: Strategies for creating value in a difficult market

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The credit crunch and the subprime crisis have changed the landscape for private investors. But that doesn't have to mean the end of the road for private equity. Good private equity firms have kept going for decades, and in this article the authors examine the options in tough times and set out guiding principles to help private equity firms keep adding value despite the downturn.

Through the boom years of 2005 to early 2007, private equity thrived, with record deal volume and readily available financing. This boom included the two largest buyout deals of all time: Blackstone's \$ 38.9 billion buyout of Equity Office Properties Trust and the \$ 32.7 billion buyout of Hospital Corporation of America by Bain Capital, KKR and Merrill Lynch. This rapid growth coincided with strong economic growth as well as a robust credit market, which allowed consumer confidence to thrive with ready access to consumer credit and home financing. Lenders were more than willing to support large private equity transactions with generous financing terms made possible through reduced covenant packages, referred to as "covenant lite," and the use of flexible interest repayment structures.

Table 1 shows the traditional buyout structure versus the "pre-crunch" buyout structure that was commonly seen in 2005 through to 2007. A key differentiator between the two structures is the use of PIK notes to finance the transaction. PIK (Paid In Kind) notes allow borrowers to make interest payments with securities instead of cash. This mechanism allows the private equity investor to take a loan and then choose whether to make the interest payments on time or in aggregate at the end of the loan period. These notes carry a higher fee burden but enable the borrower to pay in full at the end of the borrowing term instead of making the interest payments on an ongoing basis. Additionally during the boom years the first lien debt levels were decreased and replaced with second lien debt and "covenant lite" structures. The result of this structural change was that it became very difficult for a borrower to default on a loan. This structure was enacted by financial institutions that were seeing high private equity returns and did not want to miss out on the rising tide. The structural change attracted private equity firms to come back to the financing fountain with increased aggressiveness.

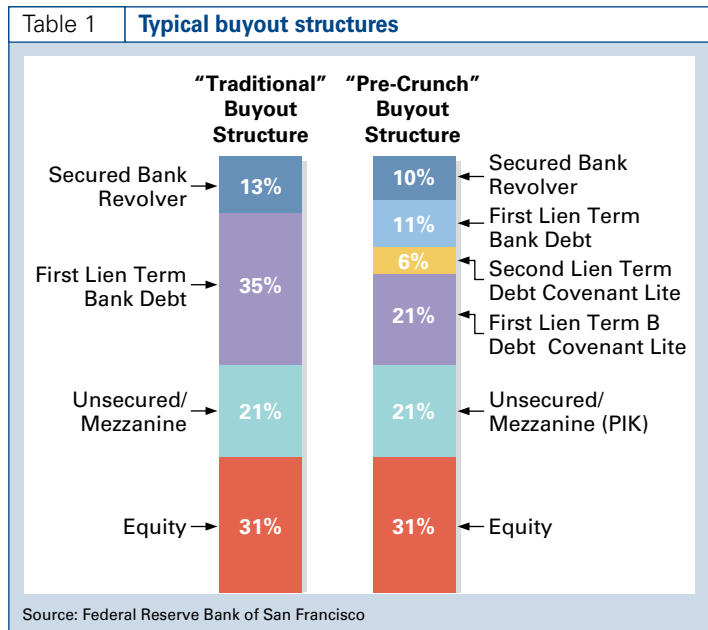


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Not wanting to miss out on transactions supported with generous financing, some firms lost discipline and engaged in bidding wars, which pushed transaction multiples higher. From 2001 to 2006 the average Enterprise Value/EBITDA multiple paid in leveraged buyout transactions in the US soared from 6.1 to 8.6x. Thanks to a fluid credit market, financial institutions were able to syndicate the debt, allowing private equity firms to continue to source deals aggressively.

In the summer of 2007, the market’s appetite for large leveraged deals all but disappeared. The downturn was rooted in the slumping United States housing market, weakened by defaulting subprime mortgages. Mortgage defaults directly impact the balance sheets of financial institutions that bundle and securitise mortgages in order to sell them as collateralised debt obligations. Due to an inherent lack of transparency of the effect of these defaults on the underlying value of these mortgage-backed securities, demand disappeared and financial institutions became saddled with debt packages that possessed no explicit market value. As the crisis played out, the securities that could not be sold off were warehoused with the financial institutions and many were written down in value. Due to the tightening hold that these assets place on credit lines and liquidity

levels, financial institutions stopped offering generous financing terms and covenant lite structures to private equity firms. Financing options reverted to the traditional buyout structure.

During times of economic uncertainty, private equity firms are often tempted to change course and become “creative” with the process of deal sourcing and portfolio company management. Some firms veer away from their core competencies to acquire a company in an industry that is allegedly “recession-proof.” Others will abandon the financial principles that have grounded their firms in sound investments in the years preceding the downturn.

This article presents a framework that the private equity professional can apply when operating a fund, in particular in the midst of an economic downturn. Our analysis is based on our first-hand experience with private equity transactions, in-depth conversations and interviews with executives in the field. We have identified several guiding principles for creating value in this environment. These solutions are not cost-prohibitive to implement and can be acted upon regardless of the size of the firm.

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1. Focus on core principles

Our experience has shown us that, in times of economic downturn, private equity firms that outperform the competition focus on the core of their strategic platform. A rising tide can allow an erratic private equity firm to satisfy its limited partners with reasonable returns. However, during downturns, the non-focused firms that do not abide by internal assessment methodologies are often exposed as underperformers. An effective private equity firm focuses on its core to outperform its competition in four realms: adherence to investment strategy, oversight of portfolio company management, effective utilisation of outside resources and reinvestment in portfolio companies.

Adhere to your investment strategy

During an economic downturn, the firms that consistently outperform the competition and return higher than average IRRs to their limited partners are the firms that stick

to their core strategies. Nearly every firm has a different mission statement and strategic initiative but, at their core, the outperforming firms concentrate on investing in growth and creating value. Often in downturns there are fewer deals to be made, making the deals that are left on the table increasingly competitive. Some firms will feel the pressure to put their committed capital to work and, in the process, will sacrifice some of their core investment strategies. Over the past 20 years, the funds that have weathered cyclical downturns are the ones that have adapted to changing economic environments without changing strategic direction.

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Privately held companies are often reluctant to sell in economic downturns due to the state of the market and the belief that they will be able to sell for more when the cycle has passed. This intuitive phenomenon feeds into the underlying supply/demand issue: many firms are competing for fewer deals - ironically the same issue that drives up deal multiples in boom times. This can create situations where private equity professionals push for transactions that are normally not in their target profile. This is being seen in the United States, where firms normally not specialising in turnaround buyouts are taking risks to acquire fundamentally flawed companies in the hope of turning them around and maximising return on investment. However, due to the internal organisation of many of these private equity firms and the backgrounds of the professionals assigned to the companies, the ideal infrastructure to support a turnaround is not always present.

One private equity professional who normally specialises in distressed deals observed that, in his opinion, the smartest thing he did was to decide early in his career that even if it meant not completing a deal for over a year he would not stray from his investment strategy.

Put oversight of your portfolio company management in place

Proper oversight of portfolio company management should be in place at all times, regardless of the economic environment. However, during downturns the proper infrastructure connecting the private equity firm and the management

team of the portfolio company can be a differentiating factor between firms that just stay afloat and firms that consistently produce above-average returns for their limited partners. The professional tone of the relationship should be set immediately post-close and, at the very latest, at the first board meeting. The firm and management should agree upon performance metrics that will be used to evaluate company performance. Additionally, the interaction should agree on an initial 100-day plan, during which a strategic and operational assessment will be performed and results reviewed with the board. Interactions between the firm and management should be ongoing and certainly not limited to periodic board meetings.

Best-in-class private equity firms have a post-close plan in place that establishes a governance standard within the timeframe of the initial 100-day plan. This governance standard establishes processes, outlines structures and relationships and defines roles in a manner that is clear to all stakeholders (see Table 2). An ideal governance standard will be based on guiding principles that should be agreed upon by both the private equity firm and the management team of the portfolio company. For example, the two parties can agree to a series of shared aspirations and

| Table 2 | | Governance standard | |
|---|--|---|--|
| Governance | | | |
| Processes | Structures and Relationships | Roles | |
| <ul style="list-style-type: none"> • Asset protection • Operational effectiveness • Value creation | <ul style="list-style-type: none"> • Board of Directors and Board Committees • Stakeholder meeting • Leadership councils • Reporting relationships • Horizontal relationships • Physical locations | <ul style="list-style-type: none"> • Board/Board Committees • Corporate Officers • Leadership Councils • Executive/Corporate Vice Presidents • Business Unit/Operating Company Executives • Corporate Center Units • Shared Services Units | |
| Guiding Principles | | | |
| <ul style="list-style-type: none"> • Shared aspirations • Measurement and accountability • Leadership capabilities | | <ul style="list-style-type: none"> • Permeable boundaries and multiple orientations • Behaviour and ethics | |
| Source: Arthur D. Little Analysis | | | |

the measurement and accountability metrics by which to achieve these objectives. Other guiding principles include the establishment of boundaries that allow management and ownership to have a degree of autonomy in the decision-making process. Lastly, a key principle that should be agreed upon is a code of conduct and an ethics framework.

Effectively utilise outside resources

Like any other company, a private equity firm functions most efficiently with the proper use of external resources. These resources include accountants, lawyers, consultants and outside advisers. For the purpose of this article, we will concentrate on the use of external and impartial board members. A characteristic of a successful firm is that it utilises external experts on the board of directors of its portfolio companies. These individuals not only offer new perspectives but can also be valuable resources for deal sourcing if the company intends to grow through add-on acquisitions.

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Firms that are currently utilising outside board representation most typically access these individuals through informal networks and industry contacts. Sometimes, these outside resources can be of great value in mediating conflict between management and ownership. Private equity firms that are successful in using this organisational model draw heavily on the outside board members to frame corporate governance structure.

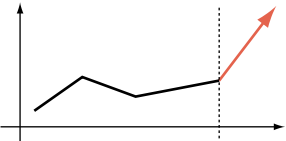
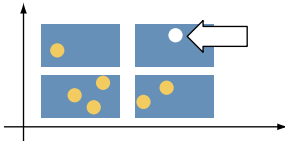
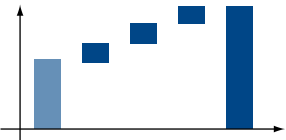

Reinvest in existing portfolio companies

Deal sourcing becomes exceedingly difficult during times of economic downturn. Private companies are reluctant to sell when the market is not strong and typically opt to wait out the downturn. In environments like this, outperforming private equity firms concentrate significant effort towards reinvestments in their current portfolios. This reinvestment is often manifested in add-on acquisitions where the firm adopts the role of a strategic buyer. Several firms hold 20-40 per cent of their funds for the purpose of add-on acquisitions. This is a great way to increase EBITDA in a portfolio company without having to extensively source a deal through internal firm resources. Having this option in place

also allows the management of the portfolio companies to be proactive in bringing their companies to new levels. Empowered management teams can be an ideal conduit to maximising value creation at a company level.

2. Conduct a rigorous pre-deal due diligence

During times of economic downturn, successful private equity firms can rarely concentrate solely on financial engineering to add value to a portfolio company. Adding value means driving EBITDA growth through a mix of revenue growth and cost improvement realisation. With financing tightening due to write-downs related to the subprime mortgage market, there is less room for error in the acquisition of a portfolio company. Because of this, the successful private equity firm will conduct a comprehensive due diligence of the target company, assessing four key areas: industry attractiveness, company positioning, value creation opportunities and exit strategies (see Table 3)

| Table 3 Key due diligence questions | |
|--|---|
| <p>1 Industry attractiveness</p> <p>Is the industry fundamentally attractive?</p>  | <p>2 Company positioning</p> <p>Does the company have a healthy position in the industry?</p>  |
| <p>3 Value creation opportunities</p> <p>Do significant value creation opportunities exist?</p>  | <p>4 Exit strategies</p> <p>Are there viable exit strategies?</p>  |

Source: Arthur D. Little Analysis

Assess industry attractiveness from a dynamic perspective

A private equity firm should always thoroughly understand the market of the portfolio company that it is considering acquiring. This analysis should include an assessment of the market potential both in the geographic region where the target is located and in other regions where expansion could be an option. The firm should look at the historical

performance of the industry as related to major economic indicators in the country. Does the market seem to move in line with the macro-economic growth of the country? Is there a pattern that can be identified?

Above all, the firm should focus on market projections over the duration of the expected holding period of the investment. This analysis should include threats and opportunities that the industry will be facing in the coming years which would force a company to make an operational or strategic adjustment (see box text for a best-practice example).

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Assessing the market – A best-practice example

While considering the acquisition of a niche manufacturing company, a private equity investor was particularly concerned with understanding the current size and potential future growth of this market. As the company made component parts for a wide variety of end-user industrial markets, there was no publicly available information for the private equity firm to access. The private equity firm commissioned Arthur D. Little to conduct a market due diligence to assess the potential accessible market size over the course of the investment holding period.

The project team conducted extensive primary research, interviewing customers, competitors and industry experts to accurately assess various opinions on the market from all angles. Furthermore, since most of the target's customers were larger manufacturing companies, the project team identified the purchasing managers and interviewed them to gauge their views on where the industry could be heading over the course of the holding period. As a final deliverable, the project team presented a robust model taking into account extenuating market forces in each end market to forecast a perceived future state of the market.

Comfortable with the analysis and the future growth of the industry, the private equity investor chose to make the acquisition.

Understand company positioning from primary sources

In addition to simply understanding the market dynamics, a properly prepared firm will have a comprehensive understanding of the target's positioning in its market. This process includes segmenting the industry by market share to understand how the target company is positioned relative to the competition. The analysis should also include a thorough understanding of the competitive positioning that the company enjoys in each of its business units.

A comprehensive due diligence program should include an initial business plan including in-depth operational improvement strategies. The plan should provide estimates for EBITDA improvements in terms of cost reduction and revenue growth as well as methods to increase capital efficiency to maximise ROE.

Conducting secondary research and reading the Information Memorandum are not sufficient methods for understanding competitive positioning. A successful firm will draw upon interviews with suppliers, customers, competitors, industry experts and management in order to formulate an understanding of the competitive landscape that the company is facing. Primary interviews are often the best place to start when trying to understand how a company is differentiating itself from its competitors. Who better to understand the factors that go into buying a boat than a customer? Who better to understand the competitive dynamics in the graphics industry than a sign maker? The outperforming private equity firm will target those who are the most knowledgeable in the given field and go directly to the source of information (see box text for a best-practice example, next page).

Identify value creation opportunities pre-close

In times of economic downturn, the private equity firms that identify value creation opportunities pre-close will profit from quick wins. Firms that wait until the first board meeting to discuss operational improvement areas and growth strategies are often the firms with lower returns and longer-than-desired holding periods.

A comprehensive due diligence program should include an initial business plan including in-depth operational improvement strategies. The plan should provide estimates for EBITDA improvements in terms of cost reduction and revenue growth as well as methods to increase capital efficiency to maximise ROE. Depending on access to the target company, the firm should strive to have a thorough

Understanding the target – A best-practice example

When considering the acquisition of a global sporting goods manufacturer, a private equity firm struggled to understand the demand drivers across the target's various product lines. Moreover, the firm wanted to know if the target was boosting its sales figures by stuffing the retail channel with excess merchandise, a practice that would limit same stores sales the following year. Additionally, the private equity firm was concerned about potential new entrants across multiple product lines, which could have the potential to decrease the target's market share over the holding period of the investment.

As part of the market due diligence, the private equity firm commissioned Arthur D. Little to conduct a thorough market survey of the top 200 global retail dealers of the target's products. Each purchasing manager was interviewed so that the firm would have a thorough understanding of the conditions that were being exhibited in each market as well as whether the purchasing manager expected to maintain order quantities over the coming years. The interviews also allowed the firm to understand the strengths and weaknesses of the competitors from primary sources.

The firm was pleased with the level of transparency that the interviews provided and recently acquired the target.

In times of economic downturn it is more important than ever to fully grasp where the portfolio company should be at the end of the desired holding period.

understanding of potential improvements in materials, labour cost, working capital carrying cost and overhead, as well as initial projections for revenue growth depending on identified growth factors. By putting a value-creation study in place, the firm sets itself up for a more credible initial discussion for the first board meeting and can hit the ground running on optimising its return on investment (see box text for a best-practice example, next page).

Formulate condition-driven exit strategies

As the final aspect of a successful due diligence program, the private equity firm should assess how it will exit its investment in the portfolio company. In times of economic downturn it is more important than ever to fully grasp

Value-creation opportunities – A best-practice example

When considering the acquisition of a privately-held packaging company, a private equity firm was particularly interested in assessing top-line value-creation opportunities pre-deal close. Without access to the target's manufacturing sites, the firm was unable to perform an operational due diligence and thus wanted to fully understand the market strategies that could immediately create value if it were to invest.

The firm commissioned Arthur D. Little to perform a market due diligence of the target with a detailed focus on quantifiable value-creation opportunities. Through primary and secondary research as well as input from senior advisers working in the industry, the project team was able to identify several parallel markets where the target could feasibly make a seamless market entry. Although the parallel markets comprised different end users, they were not heavily concentrated and the target would be able to pose a unique value proposition.

where the portfolio company should be at the end of the desired holding period. This assessment should take into account the core competencies of the company and whether these lend themselves to a particular exit strategy.

All avenues for exits should be initially considered, making explicit the conditions that will have to prevail at the end of the holding period to make the investment. A sale to a strategic buyer might not seem realistic at closing but, two years into the investment, the research performed pre-deal could lend itself to a credible strategy. The well-prepared firm sets up a working exit strategy for each portfolio company pre-close and alters that plan through the holding period as needed (see box text for a best-practice example, next page).

Preparing the exit – A best-practice example

When evaluating the acquisition of a market-leading adhesives company, a private equity investor grew apprehensive that the management's growth plan would preclude the next owner of the company from selling to a strategic buyer. For a year prior to the acquisition process, management had been collaborating with a major OEM to supply private label products for certain product lines in order to break into new end markets. Forecasts predicted that such a partnership would boost revenues 10-20 per cent over a three-year period, with further growth possible with additional product line additions.

While the private equity firm was pleased with the growth of the target, the joint venture with the major OEM was cause for concern. The private equity firm did not want to be limited to financial buyers at the end of the holding period and feared that a partnership with a major OEM would preclude certain strategic buyers from acquiring the company at full market value. Therefore, the company relied on Arthur D. Little for a detailed market and operational due diligence, which ranked both strategic buyers and financial buyers on a scale of their likelihood to bid for the target. The analysis took into account current joint ventures in place at these companies, financial strength, product synergies and past investment history.

In the end the private equity firm felt that there were, in actuality, several strategic buyers that would in all likelihood have a strong desire to purchase the company based on product portfolio fit, as well as market expansion strategies. The firm closed the deal shortly after the analysis was completed.

Insights for the executive

With numerous large-cap private equity transactions falling through in the past year, much attention has been paid to the apparent downfall of the private equity industry. What detractors fail to realise is that the industry is very resilient. Private equity has been around for over 30 years and has seen cyclical downturns, recessions and even double-digit

interest rates. The firms that have survived the downturns have been the ones that maintained their focus on core competencies and that made sure they were thoroughly aware of how to create value in their investments. Firms that continue to operate under these principles will continue to add value to their portfolio companies and will weather temporary setbacks in the credit market.

While economic downturns often have a detrimental impact on private equity deal-flow, such downturns also draw attention to the operating models that are highly successful. Well-run firms often differentiate themselves and become the standard for best-in-class operations in the industry. The prescriptions that we have outlined are not unknown measures that will provide a quick fix. These recommendations are intuitive to some and many firms have incorporated various aspects of them into their approach. However, it is the firms that design a strategy and framework around these recommendations that prove adept at creating value during economic downturns.

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