

PE-backed firms setting pace despite downturn

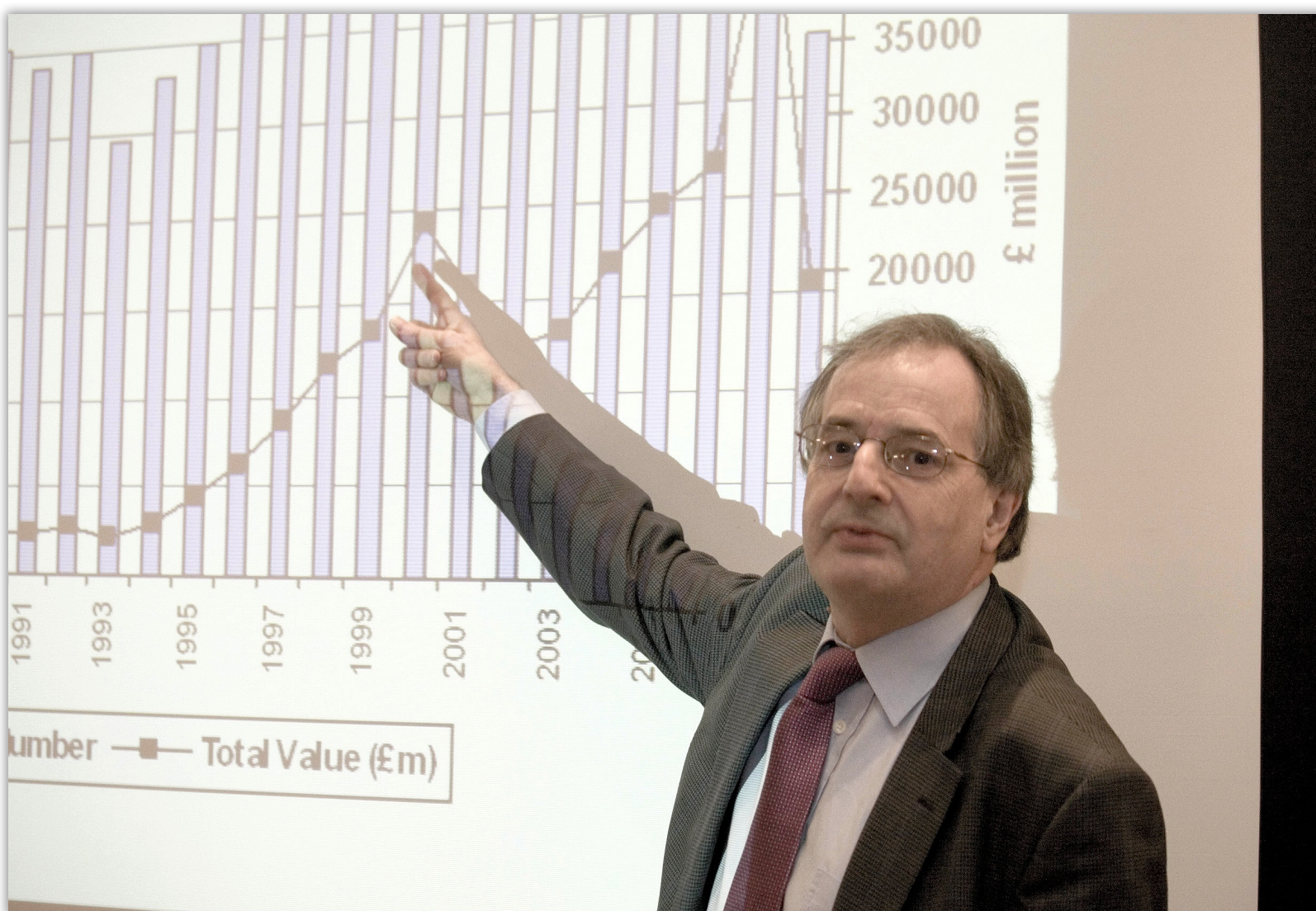
Private equity backed companies have outperformed both listed and private businesses during the recession (Source CMBOR/CMRC). Is this sustainable? **Prof Mike Wright**, from CMBOR, and **Nick Wilson** from CMRC, report

The second wave of private equity (PE) backed buyout transactions reached an all-time peak in 2007. Since then, the worst recession since the 1930s has meant that prospects for many businesses have become severely challenged, including those that had been subject to a buyout. The rapid growth of the PE and buyout market has attracted considerable attention from policymakers, the media and unions. Critics of these transactions claimed that the high leverage typically associated with these deals would lead to short term performance horizons, reductions in employment, and increased insolvency risk particularly in an economic downturn.

Defenders of PE countered that favorable credit conditions, notably low interest rates, were a major driver of the amount of leverage in PE deals and that, in the early stages of the buyout, optimal leverage may be high. A focus by PE firms on investing in stable sectors with strong cash flow, and in companies with potential for performance and productivity improvement, may mean that portfolio companies are better able to withstand economic downturns. Close monitoring and timely intervention by PE investors to deal with financial problems may also mean that the performance of portfolio companies is maintained.

In a recent study we assessed the performance of PE-backed buyouts and comparable private and public firms that have not experienced such transactions, using a large dataset almost the UK population of firms, covering the period before and throughout the recent recessionary cycle (1995-2010). We also took into account a range of other factors in order to isolate the impact of PE involvement. We found that, contrary to some commentators' expectations, during the recent severe global recession, PE-backed buyouts experienced higher growth, productivity, profitability, and improved working capital management, relative to comparable firms that did not experience such a transaction. This evidence is consistent with PE firms both adding more value to portfolio companies and being more actively involved in taking timely action to assist their investees.

In a related study we also found that after taking into account various risk factors associated with insolvency, notably monitoring by auditors, active creditors, operational risk and financial



Prof Mike Wright, from CMBOR

characteristics, private equity backed buyouts were less likely to enter administration than similar non-PE backed companies. PE-backed buyouts may be better able to resolve problems in a timely manner through financing restructuring, etc. Interestingly, we also found that when PE backed buyouts do fail, creditors on average recover twice as much as the creditors in listed corporations that enter administration.

While there was some recovery in the private equity and buyout market during 2010, after a collapse in new deal activity in 2009, renewed macro-economic uncertainty is again casting its shadow over the market. Both new deal volume and value will be well down in 2011 compared to last year. Indeed, by the end of the third quarter, £9.9 billion worth of new deals had been completed compared with £19.2 billion for the previous year. However, one bright spot has been the renewed interest in the lower mid-market deals in the £10-100m range.

Reflecting the constraints on bank lending, the amount of debt in the pri-



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private equity deals that are being completed has been declining sharply since 2007. The average share of debt in deal financing structures now stands at 25 per cent its lowest ever and half the 2006 level. Indeed, we are seeing a number of equity only deals. Earnings multiples being paid for the relatively few big deals above £100 million have fallen from an average of 15.6 in 2010 to 12.6 in the first nine months of 2011. In contrast, reflecting increased PE firm interest, average deal pricing for deals in the mid-market range (deal value of £10-100 million) rose from 10.9 in 2010 to 13.5 this year.

Private equity firms have always aimed to match the debt in financing structures to the ability of firms to service it. Such a low level of debt places less pressure on portfolio companies from this direction but in the absence of the benefits of debt in leveraging up the returns to private equity firms, there is a need for portfolio companies to show gains from growth and efficiency gains.

Private equity firms may seek to do deals in more resilient sectors in the

current climate. Some sectors have been especially badly hit in terms of new deal activity but also in terms of problems for existing deals, notably the retail sector in general. In 2010 Retail recorded £2.8 billion from 28 transactions and this year value is £1 billion from 22 deals.

In 2010 the exit market improved with total exit volume rising to 275 and creditor exits (administrations) fell to 115. So far this year, failures of private equity backed deals have continued to decline as private equity firms have taken action to restructure portfolio firms in distress ahead of formal administration. Using data from The Insolvency Service to the end of the first half of 2011, PE-backed buy-outs accounted 0.8 per cent of all UK company failures by the end 2010 and is again at 0.9 per cent in the first half of this year.

Overall, we see continued adaptation in the market in terms of the types of deals done, the way they are structured and the involvement by private equity firms to ensure the sustainability of returns.