

Private Equity's role in turnarounds, workouts and insolvencies



FEATURE ARTICLE

DAVID F JONES, MANAGING DIRECTOR, CHAMP PRIVATE EQUITY

Ed: This is the first in a series of articles to be published on the theme of turnaround and restructuring in 2007.

Introduction

Private Equity (PE) can play an extremely constructive role in many turnarounds, work-outs or insolvency situations (**turnarounds**). In a turnaround PE can bring three valuable attributes to the table: risk capital, a three to five year view, and clear and active assistance and governance. PE has demonstrated that it can participate in virtually any industry, and that it is highly experienced in successfully merging businesses – which can often be of real benefit for a business that is struggling standalone. However the insolvency process is not well understood within the PE community, and relationships could be strengthened, particularly in preparation for when the business cycle turns. PE is prepared to tackle very complex situations and invest substantial time and resources, provided it can see a clear path to a transaction occurring. In this vein, the typical Australian administration-insolvency process can work for PE, although arguably the process could be improved by adopting a number of the elements of the US Chapter 11 process.

These themes will be discussed below. These thoughts are largely focused on transactions with larger, later stage businesses, but also apply to more early stage venture investments.

What Private Equity brings to the table

Private Equity typically brings three factors to any investment, all of which can be very relevant in any turnaround.

Firstly PE brings an active partnership with management, with an engaged and focused board regime, regular meetings and frequent (typically weekly) KPI reporting. A PE backed company board will also usually have, in addition to the PE executives and the company's senior team, other non-executive directors. These directors will be selected for their relevant industry experience, often having previously run similar businesses.

All directors will be shareholders (PE, management and independents) and as such decision making is rapid, and the group is extremely focused. All parties have 'skin in the game' and so are driving for the same outcome – growing the business. A recent study by McKinsey has shown that, in the more successful PE firms, the senior PE partner who made the investment spends around half their time in the first 90 days post investment at the company working on the business. This intense level of commitment to driving the business, and disciplined monitoring of performance, can be extremely helpful in any turnaround.

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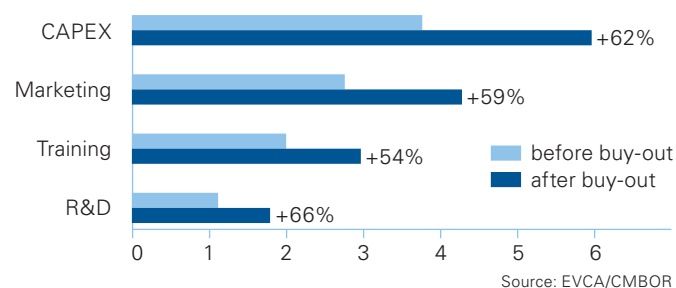
Secondly PE invests with a three to five year view. The objective is a sale of the business (part or whole) at the end of that period. As such, while PE is very focused on interim performance and monitors results frequently, the three to five year destination is the central objective. This is in contrast to some

companies, often public ones, which can become very focused on producing steady regular EPS growth. Similarly a turnaround may have been under pressure from its financing or other commitments to produce regular steady returns, service debt etc. In either case the company may not have been able to contemplate an investment if it would not bear any fruit for a number of years. PE can do this, and can structure its financing so a two or three year pay-back project, provided the return is of an adequate size for the risk and the time period, can be contemplated. PE can also invest in stages, and put in top-up capital if needed if an investment under-performs.

A typical scenario where PE can be most effective is when a business, for whatever reason, has been under-nourished with capital. This is often the case in turnaround situations.

Finally PE brings fresh capital. A common misconception about PE investments is that due to the typically higher leverage in PE capital structures, and the often high initial purchase prices paid, that there is no capital available for investing in the business.

This could not be further from the truth. A key tenet of PE investing is that it derives out-performance in its businesses by backing a business plan not only with people but also with capital. A study of buy-outs in Europe by the European Venture Capital Association (in the chart below) shows that spending on capital expenditure, marketing, training and research and development is, on average, of the order of 50-66 percent higher post-buy-out than pre-buy-out, as a percentage of sales. This fresh capital is often what is most dearly needed in a turnaround, and is the fuel for business growth.



Austar demonstrated what PE can bring

In the case of Austar, which CHAMP Private Equity committed to investing into in late 2002, the key value of PE was clearly demonstrated. At the time Austar was a listed company with around 700 million shares trading in a range of 12-16 cents per share. It had listed five years earlier at \$4 per share, and reached a peak of over \$9. Austar had A\$400m of bank debt which was in default as it had an EBITDA in the 2002 calendar year of less than \$25m, after two years of heavy losses, it was well adrift from its bank plan. The company's major (35 percent) shareholder was a Denver-based company called United Global Com Inc (UGC). UGC had expanded rapidly in many non-US markets and was suffering similar under-performance globally to Austar locally. All these factors meant Austar had a distant, distracted major shareholder, a set of lenders disappointed with the company and very focused on the next quarter's results, and no capital for expansion. Austar is a Pay-Television operator and as such every time it takes on a new customer, while it is EBITDA positive, it is cash negative (the cash costs of the sale, the equipment, and the installation take around two years to be paid back). So growing out of its troubles was very difficult.

CHAMP was able to address all these matters when it bought into Austar. CHAMP brought disciplined local leadership to the board table, re-set the banking arrangements to give the company a reasonable medium term runway, with appropriate head room for any bumpy air, and put new capital into the business. Around half of this new capital went to reduce the senior debt levels but importantly around half went into working capital to fund growth. After three years and a lot of work Austar's EBITDA was \$120m, the lending group had been refinanced (oversubscribed), and the shares were above \$1.00. (Today the shares are above \$1.50.)

Flexibility around industry, style of investment, stage of company

PE has demonstrated it can be effective across a wide range of businesses. Across the PE industry in Australia over the last two decades, it is hard to find an industry sector or a stage of business where PE has not successfully made a contribution. For example, over the 20 years of the CHAMP Group it has invested in over 60 companies across a diverse set of industries.

PE can participate in quite small businesses, and ones that are relatively early stage, all the way through to the large buy-outs of mature companies that have been in the media recently.

Importantly, PE is flexible in how it participates. The bulk of the PE business has traditionally been focused on a PE alone or with other PE firms jointly buying a division of or a whole business. However PE is now also partnering regularly with corporate groups to jointly buy assets, participating in public companies which remain listed (Austar was an example of this), and other variations on these themes. PE has a preference for control or joint-control: less than 25 percent is less attractive for later stage PE investors.

Clearly there are some attributes, such as an understandable and predictable cashflow profile, that make a business more attractive to PE. However insolvency practitioners should not assume that PE will not be interested in a particular asset or situation just because it appears non-traditional for PE. On the whole, the PE firms are open to ideas and welcome creative discussions.

Mergers as a solution

PE has deep experience in executing acquisitions and in making them work successfully. 'Bolt-on' acquisitions are acquisitions made by an already PE-backed company, often with the PE firm providing both execution assistance and additional equity capital. As an example of the depth of this activity, last year CHAMP Private Equity made three new investments, but in addition completed 14 'bolt-on' acquisitions for existing CHAMP-backed businesses.

Mergers, particularly where a struggling company can be 'tucked in' under a strong 'platform' company, can be an effective way to drive turnaround performance.

When assets are in administration or receivership, visibility on the part of the administrator or receiver around which PE-backed companies are aggregating in which industries could be very useful. Advisers investing the time in this, particularly as the business cycle turns, I suggest could be very valuable.

Work-outs, insolvency processes not well understood by PE

With the strong underlying economic fundamentals and generally good investment selection by PE firms over the course of this decade, there have been very few traditional bank work-outs with PE involvement. As such there is a real dearth of experience in how a work-out can play out. Similarly, excluding the early stage venture capital end in the wash up from the 'dot-com' correction post 2000, there have been relatively few voluntary administrations and receiverships in PE backed businesses. As a result there is limited knowledge within the PE firms of how these processes work or awareness of the possibility that PE could play a role. Similarly I suggest that PE could be higher in the prioritisation of the advisers running these processes.

As one adjunct to this, relationships could be further developed between the two groups – the PE firms and the work-out and insolvency practitioners. It makes sense to educate both groups about each other's needs and objectives, and I suggest would be time well spent for when the cycle turns.

PE's priorities in any process

PE places a real premium around certainty of outcome. Time is a scarce resource in PE firms, and so it is very important that there is visibility around how an asset may change hands. PE seeks to avoid situations where it invests a lot of effort, only to find the asset is removed from sale, or another claimant can disrupt the process, etc. Naturally this all assumes that any PE offer will be competitive from a value perspective to have any hope of success.

Complexity is not a concern for PE firms. Most PE firms have the manpower capacity to devote high levels of resources to interesting situations. PE firms are structured so they can take the time and effort to invest in often complex processes.

In Austar, as an example, CHAMP was able, after some creativity (including some precedent setting waivers from ASIC) and a lot of hard work (around two man-years), to find a way to buy out Austar's junk bond holders in the Bankruptcy Court of New York (at a steep discount to face value I might add). These junk bonds held 51 percent of Austar's shares. This purchase gave us enough certainty of outcome that we were prepared to invest the time in working out the other key requirements to getting a deal done

– including agreeing a joint control regime with UGC, resetting the bank debt, injecting capital into the company, and the like. This was a demonstration of PE's ability to invest in a complex process, provided we had visibility around an end game.

PE also needs access for due diligence. PE can be fast, and focused in its review, but as 'outsiders', unless the asset in question could be attractive to a pre-existing platform investment such that we are industry 'insiders', PE will need access to the company for due diligence. We need it, and our lenders require it.

Looking ahead

A few observations about some scenarios that may play out in turnarounds in the future.

Firstly I do expect that PE firms will play more locally in buying into distressed debt positions. This has been a very active space in the US.

Secondly, the recent trend towards widely dispersed loans, where there are maybe 30 or 40 participants in a bank syndicate, will have some challenging implications

in terms of executing a work-out. I have heard it expressed as 'wont be able to find a table big enough!'.

Finally, the local process of voluntary administration and receivership seems to be working reasonably well, and PE can have a role to play here as discussed above. However I would observe

that the US Chapter 11 process does seem to be particularly effective in resuscitating businesses, and preserving capital. It appears to me that the most relevant differences between the two systems that could be behind the effectiveness of the US system, apart from the fact the US system is longer established and more entrenched, are threefold. Firstly the longer stipulated time period that the US system gives for a restructure. Secondly the US has no personal liability for the participants. And finally the clear priority of any new debt injected during the US process. As an outsider I would suggest that further clarity or amendment along these lines could greatly assist the Australian system in preserving capital for all. ▀

Note from author: *Regardless of whether these future notions play out, it is clear to me that there is a real opportunity for PE firms and the workout-insolvency practitioners to work more closely together in the future. PE can bring many attributes to the table that can greatly assist many turnaround situations.*