

# Private grief

Equity houses without the resources to put some more 'skin in the game' when their investments hit trouble may find themselves left with little to show for their money, writes **Azadeh Khalilizadeh**

**S**truggling businesses with high debt levels have had a profound effect on private equity investors, as they suffer fewer realisations and increasing default rates. The pressure is on for private equity houses to play smart and have a greater, proactive part in the structures of deals going forward.

"We have a novel situation now, with a higher proportion of deals going bad as businesses are hit by a triple whammy", says Michael Berry, ex-Nomura Leveraged Finance Chief and CEO of advisory boutique Versatus.

"First, the economic recession gives lower corporate profits. Secondly, the financial crisis means acquisition prices as a multiple of profits have fallen, so company valuations are doubly impacted. Thirdly, banks are in trouble so they will be prepared to lend less money, more expensively and they will be more desperate to claw out of restructuring cases."

One recent example of a business hit by the "triple whammy" is photographic and camera retail giant Jessops. The company saw its bank (HSBC) take a 47 per cent stake and warned that due to its historic levels of debt, any restructuring solutions, including a debt-for-equity swap, would be likely to wipe out the equity value of the chain.

Debt-for-equity swaps are becoming an increasingly common way for businesses to stabilise their balance sheets, but can be bad news for private equity investors, according to lawyer Tony Edwards of Stephenson Harwood, as they usually dilute the value of the existing equity stake.

But where that leaves the private equity investor varies from deal to deal, says former R3 President and Talbot Hughes McKillop Partner, Murdoch McKillop.

"The key variables are the quality of the underlying business, whether there has been a covenant breach due to a shortfall against plan, the nature of the covenant breach, the investor's rights under the loan documents and whether new money is required and, if so, the size of that requirement."

But the lower the company's value, Michael Berry explains, the less influence the private equity firm has, to the point where if the value does not exceed the debt the private equity house will have "little or no remaining economic interest".

The recent ruling concerning IMO Car Wash highlights the weak bargaining position of leveraged fund investors and junior mezzanine lenders when it comes to debt restructuring of a distressed company. In that case the High Court favoured the valuation process that gave senior lenders

full control over the struggling business, rejecting the method proposed by junior creditors.

Some commentators believe private equity firms may retain some economic interest, even where the valuation suggests that they are out of money. Michael Berry says this arises where lenders consider the private equity house to be "operationally important" to the company and not just a "relatively passive investor", by providing certain services such as negotiating major contracts. Murdoch McKillop says a private equity house has a much better chance of defending its position if there is a "new money need" and the private equity house can bring significant cash.

But a problem occurring now is that private equity houses no longer have access to significant amounts of capital on the credit markets. In this scenario, says Marc Fecher, partner in Kingston Smith's Specialist Corporate Finance department, the private equity investor would have less influence over the direction of the business and is "highly susceptible" to forced decisions and has less negotiating power.

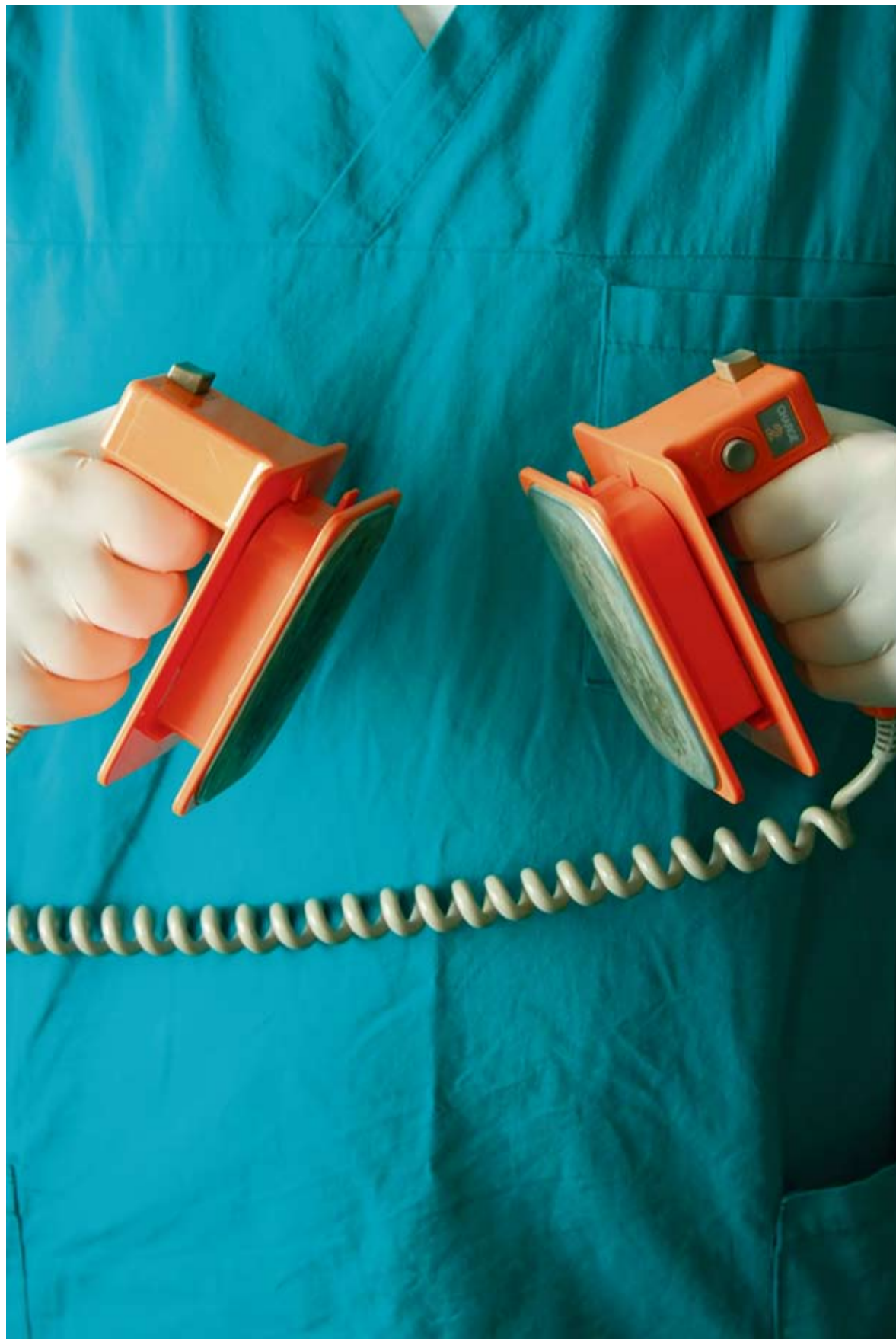
Both Edwards and McKillop believe the plight of the private equity investor depends on the specifics of each situation. "In some circumstances it may be possible to push out the issue by negotiating a reset of the covenant breach, a default waiver or an equity cure," McKillop says. "If the private equity house is unable to bring anything to the restructuring, they are usually left with a token stake or even nothing."

## STUCK IN THE MIDDLE

The situation for private equity funds is not much better where they have supplied mezzanine funding rather than holding equity. "When it comes to mezzanine funding, the plight of the private equity investor depends on the legal structure and where the value breaks," McKillop says. "If they have secured mezzanine debt, that may provide more leverage and the private equity house may be able to negotiate a better deal as part of the restructuring."

Otherwise, according to Tony Edwards, the mezzanine lender will have "little to say" in what happens to private equity-backed companies which are in distress because they rank behind the senior lenders.

Michael Berry at Versatus believes the current crisis has seen valuations going down so steeply that the mezzanine is hurt. "There is now a greater risk than ever before for mezzanine funds as companies are underperforming and their value is dropping, often to the point where



A higher proportion of deals are going bad due to a 'triple whammy' of effects brought about by the economic conditions

the mezzanine is partially or even completely under water."

But at the end of the day, Berry adds, private equity and mezzanine funding is all about "taking a risk with eyes open."

There are limited powers, which vary from deal-to-deal and jurisdiction-to-jurisdiction, for a mezzanine lender to enable it to delay or influence the process. One method of influence, Berry explains, arises from the fact that it shares in the security and the provisions of the inter-creditor agreement with the senior lenders. This may give it "worthwhile nuisance value", such that it may be preferable for the senior lenders to

bring it into the restructuring with a decent equity share, rather than seek to eliminate it altogether.

## LESSONS LEARNED?

From a bird's eye view of the economic climate, Berry is confident that the current private equity situation is "not a universal problem."

"Looking at private equity investments over two to three decades, private equity investors have made pretty good returns," he says. "Many are going through a bad patch at the moment but some are also going well."

Berry suggests that the current crisis exposes which private equity firms are actually "smart" and which have

been successful mainly through either financial engineering, or simply benefiting from the long bull market when most companies seemed to keep increasing profits and most could be sold at a profit.

Going forward, the pressure is on for private equity houses to focus more on deal origination, creating growth and "value add" as well as securing a greater, more active role in the structures of deals. "By extensive due diligence, careful planning and employing vast experience, the successful private equity investors are able to identify the majority of the risks they are taking so that they are not hit by too many surprises," Berry concludes.