The big, bad wolf

Executive summary

- Whether the private equity market is key in terms of adding value or simply ruthless, the treasurer's role in a private equity-owned organisation indisputably becomes more challenging, interesting and central.

- Private equity can change the way in which treasurers view cash management, bank relationships and legal structures.

JULIA BERRIS SUGGESTS IT IS TIME TO LOOK MORE CLOSELY AT THE POSITIVE ASPECTS OF PRIVATE EQUITY INVESTMENT.

The media has been filled lately with stories showing the private equity market to be the big bad wolf of UK industry – closing down factories, sacking thousands of employees, stripping assets and generally turning businesses upside down only to disappear in a few years' time.

If media perceptions were an infallible guide to the truth, treasurers could be expected to run and hide as soon as they got a hint that a private equity house was sniffing around their company.

But out of the media spotlight, is it really all that bad? In a recent interview with the *Financial Times*, Damon Buffini, Managing Director of private equity fund Permira, argued that all the good things about private equity have been ignored.

Buffini said that the positive aspects of job creation, increased productivity and the creation of a UK economy that is effective in global investment had not been discussed as freely as the negative points that have been highlighted over the past year.

With this fast-paced global phenomenon showing no sign of slowing, treasurers clearly need to consider how a private equity takeover of their employer could affect their department.

A DIFFERENT EMPHASIS Jonathan Clarke, Group Treasurer at food company RHM, has worked both in a plc treasury department and in a private equity-owned corporate treasury function. He says there a different emphasis when working with private equity: "The nuts and bolts of cash management are crucially important. Because private equity houses are typically more highly leveraged, you have got to be sure of where the cash is and that you can get the cash out in terms of managing liquidity."

A greater emphasis on operating cashflows affects how the treasurer will work on a day-to-day basis, explains Clarke, and this shift in mindset needs to be recognised quickly.

He says: "You must always be thinking, cash, cash, cash. You have got to be absolutely clear about where the cash is being generated. You have to get behind the accounting and reporting of cash and make sure the underlying cash is there in the appropriate place so that the banks can be repaid."

So do treasurers already apply this focus on cash management to the extent that the private equity industry requires?

Graham McDonald, Head of Fund Investment at bank group HBOS, argues that sound treasury practice and good cash management should include this rigorous understanding of where cash is located in any kind of business.

McDonald, says: "I don't think cash management is materially different. Cash management is certainly key. As part of the growth story for a private equity-funded company, there might be a strong

Box 1. Stylised private equity structure

Although many variations exist in practice, the generalised structure of the typical private equity fund conforms to the following principles, *writes ACT Assistant Director, Policy and Technical, Martin O'Donovan.*

- The fund life of 10 years sets a backstop to a timetable for the realisation of assets.
- Capital commitments are provided by limited partner interests. Minimum subscription of £5m, so smaller investors contribute via a fund of funds.
- Bridge finance is available to a fund so it can start to invest before finding all the subscribers. Otherwise it is not geared at this level.
- There is minimal secondary liquidity for investors.
- The capital structure for the fund's investments can involve many layers of equity and debt provided at different levels in the holding company hierarchy – for example, equity, payment-in-kind notes, subordinated mezzanine debt, high-yield debt, senior debt, second lien debt, secured bank or private placement debt.
- Debt to equity ratio is 5:1.
- Debt to EBITDA ratio: six times.
- Subsequent refinancing and return of capital if performing well.
- Eventual exit via an initial public offering (IPO), trade sale, or secondary sale to another private equity fund.

emphasis on capital expenditure or the return on capital employed, but these issues are apparent for many other companies as well."

The traditional role of treasurer is closely aligned with cash management and most treasurers would take this aspect of their responsibilities very seriously. However, in such a highly leveraged situation, the pressure of performing good cash management skills may be that little more pronounced.

GREATER FOCUS Patrick Dunne, Director at private equity firm 3i, says: "In a more leveraged situation or capital-efficient structure, the focus on the treasurer is clearly greater than it is in a corporate environment. This is because the cashflow is critical to success. The vigilance with which private equity firms monitor cashflow and banks providing the debt is a lot more intense."

Dunne argues that the business has inherently altered once private equity investment becomes a factor. The more highly leveraged structure enhances the role of the treasurer, making it more of a central position than in a plc.

Dunne says: "Senior management are all very involved with the equity and this is a big driver of how they perform. You might find that the treasurer becomes part-owner. This will evoke a very different mindset and shift in attitude. I think it is all very favourable for a treasurer."

Cash is so crucially important in this kind of environment because of the typically highly leveraged position of the private equity-owned company. This makes the relationship a treasurer will have with banks quite different to the relationship experienced in a corporate.

Building up strong relationships with banks and finding the banks that you can rely on and trust in times of need are an important part of what every treasurer does.

The importance of ancillary business often means that treasurers not only have the pick of the bunch where banks are concerned but also have banks bending over backwards to please them. This is quite different to a private equity-funded business.

DIFFERENT BANK RELATIONSHIP Clarke says: "You are working within a very different part of the bank. They have typically already earned their fee on the transaction from the private equity house, so it is a very different relationship than with a plc, where the banks are obviously a lot more sales-oriented."

Clarke goes on to explain that banks will only lose money with a plc setup if things go catastrophically wrong. However, in a private equity environment, the banks are a much bigger stakeholder. If the company does experience problems, it will be the banks which are very quickly out of pocket.

He says: "Banks on this side are much more analytical and much more focused on the transaction. They expect you to spend more time with them to make sure the private equity deal stacks up and the risks involved are understood."

Dunne agrees that corporate treasurers may be more used to a different approach and attitude from their relationship banks.

He says: "If you are a very large corporate and have very strong bank relationships, you will most likely be used to being the customer and being treated with the utmost respect. Everyone wants your business and they are banging down your door."

McDonald argues that the relationship between the banks is not as far removed from the corporate style as some might assume. Viewing the private equity-funded company as drastically different is not always necessary nor appropriate.

He says: "For any entity that has a leveraged structure, the banking relationship is key. There is strong emphasis on meeting the bank covenants. It is more focused in any leveraged structure. The room for error in private equity-funded companies is maybe not so wide. You would have to be absolutely sure in terms of planning that all the risks have been identified and mitigated."

UNDERSTAND THE LEGALS Understanding covenants and operational cashflows is not the only aspect of bank relationships that you need to be aware of, argues Clarke. The legal aspects of private equity deals and how they alter the treasury function are also very important.

He explains: "The legal structure is different. Typically, a private equity structure is multilayered in terms of the financing. You have got to be prepared for legal costs and legal support for managing the banking relationship."

There is far greater control of the disposal and restructuring of assets because of the banks' focus on the risk of insolvency. Clarke argues that what would appear to be a relatively straightforward transaction for a corporate could be far more complicated for a private equity-backed company.

He says: "For example, you have to be sure that somebody in a division doesn't arrange operating leasing that is in fact classified as a finance lease, thereby inadvertently tripping a bank covenant. You have to have much tighter controls over those sort of areas."

The private equity influence catapults the treasurer to a much higher position in the company, performing more tasks and being more heavily involved in the operational aspects of the business.

While private equity continues to be criticised for its ruthless business strategies, the business model for this type of investment has had some success.

Clarke says: "It has been accused of short-termism, stripping costs out of a company and selling back to the market. There is an equally strong view that these firms are able to take a three- to five-year view in terms of building the business up, bolting things on and restructuring them so they are adding value."

Whether you see working in this kind of environment as a different role for treasury or simply as an altered emphasis on cash management, it is surely a certainty that there will be many more treasurers working for companies backed by private equity over the coming years.

Dunne says: "There is no doubt in my mind that the treasurer's role becomes more prominent, challenging and interesting. It is potentially a lot more rewarding."

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