Two sides of the coin

GRAHAM BUCK REPORTS FROM AN ACT CONFERENCE ON THE IMPACT OF PRIVATE EQUITY DEALS ON THE ROLE OF THE TREASURER AND HOW THESE COULD BE AFFECTED BY THE CREDIT CRUNCH.

Why does private equity suffer such a bad press? The sector is undoubtedly a valuable source of income for companies, with private equity funds raising €112.3bn in 2006 and investing around €71bn.

Despite the media focus on mega-bids such as Boots and Sainsbury, most transactions (just under 78%) concern small companies with under 100 employees. The industry has learned its lesson from the highly leveraged deals of the 1980s, such as Isosceles and MFI. Today, both major political parties are keen to continue the momentum generated in recent years by private equity deals and to maintain the huge industry that has developed around them.

Private equity's champions insist its over-riding aim is laudable: to build value for all an acquired company's stakeholders, to bring its people together as partners, and to enable the company to achieve targets faster and more effectively unfettered by restrictions such as quarterly reporting.

But while the intervention of private equity has turned around the fortunes of many struggling companies, it is still regarded by many as interested in little more than asset stripping and slashing costs, largely through cutting jobs. This perception is hardly surprising. As John Singer, Managing Director of Advent International, observes, private equity firms have been "lousy" in defending their record, both in the UK and the rest of Europe.

Singer was speaking at the recent ACT-organised and PricewaterhouseCoopers-hosted conference *Private Equity and the Role of the Treasurer*, which considered how the environment had changed since last summer's credit crunch.

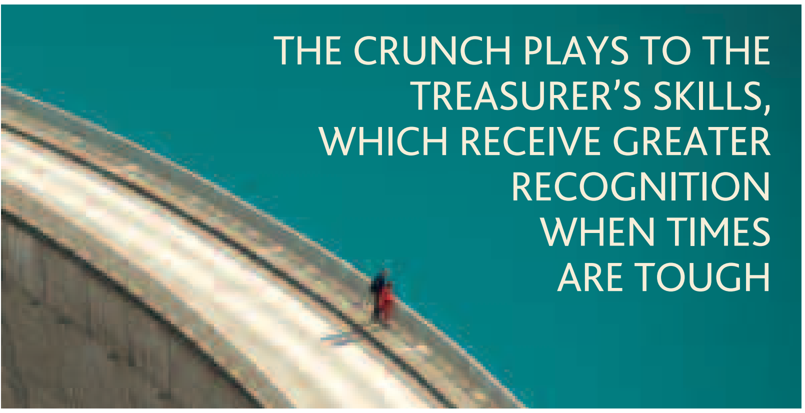
Executive summary

- **The message from the conference is that private equity deals can enhance the treasurer's role, but that there are a number of pros and cons that treasurers need to consider.**

As he observed, the prices paid until midway through 2007 were very high. Although they have come down since then, fewer companies are likely to come up for sale in the coming months. Financing is still available, but on a deal-by-deal basis, and the terms and values very different from a year ago as credit risk analysis is relearnt by the banks. This return to fundamentals may be no bad thing, as companies once again focus on their core strategies and private equity on building value.

THE WALKER REPORT The conference was held in the same week Sir David Walker's report on the private equity industry was issued. It suggested that major companies acquired by private equity should follow the same reporting standards applicable to listed companies, while the private equity firms themselves should issue an annual review outlining their investment strategy and the companies they own. However, the code proposed by the Walker review is voluntary.

According to Peter Matza, the ACT's Policy and Technical Officer: "Large private equity companies have a responsibility to report, but Walker may not be the place to be setting out public policy for all



private companies, and it hasn't necessarily served private equity well." Matza believes the report reflects a negative view of capitalism and value creation.

Another conference speaker, Michael Fallon, Conservative MP and Deputy Chairman of the Treasury select committee, voiced concern that if the self-regulation proposed by Walker was ignored, politicians might subject the sector to legislation.

"Walker has probably put the industry in a worse position, as there is a large degree of ignorance," Fallon said. "We underestimate at our peril the fragility of the private equity industry's roots in this country; it wouldn't take very much to shift the main funds from London to Dublin or Zurich."

The conference also addressed the issue of whether the credit crunch could signal the end of the private equity industry and affect the treasury function.

With investors cautious, there needs to be a compelling reason for a private equity deal if financing is to get under way, said Ian Fleming, Treasurer of department store chain Debenhams.

According to Simon Walker, Chief Executive of the British Venture Capital Association, as tougher market conditions will make mega-deals harder to pull off there will be a greater emphasis on the mid-market and bringing distressed companies back to economic health. This should, in turn, improve the public perception of private equity.

And, David Stebbings, Head of Treasury Advisory at PricewaterhouseCoopers, said the current period of re-evaluation, which would involve more mid-market deals, would renew the focus on treasury's core activities. "The crunch plays to the treasurer's skills, which receive greater recognition when times are tough," he added.

A WINDOW OF OPPORTUNITY So how can the treasurer add value to private equity involvement? By taking advantage of "a window of opportunity", suggested Fleming, whose own experience came when Debenhams was taken private at the end of 2003 by the Baroness Retail Consortium. The "window" is the expectation of shareholders that, post-acquisition, action will be taken and targets – such as setting up a cash management system – accomplished within a relatively short time period.

This requires the treasurer to be a communicator as well as an accountant, so the role may not suit an individual reluctant to pick up the phone and talk to investors.

"In our case, the window of opportunity was 60 days," Fleming recalled. "Clear goals were established regarding cash generation and cash profit, which were very helpful from the treasury viewpoint."

Among these goals was a strengthening of the cashflow reporting system, which was identified as inadequate during the due diligence stage. Following the acquisition, it was replaced by a daily, 13-week rolling cashflow forecast that ensured incoming cash could be used much more quickly to enhance working capital.

Treasury policy, which addressed the risks faced by the business pre-acquisition, also required redrafting, not least because the debt load immediately rose from £130m to £1.4bn.

"The treasurer typically gets presented with a done deal, and his or her task is to work with the resulting increase in financing," Fleming said. "However, the treasury role changes as the acquisition gradually recedes into the past."

The change is likely to involve a shift from a tactical role to more of a strategic one. One of the tasks is to develop the relationships – which can often be uneasy – between the individuals involved in the private equity acquisition and their bankers.

Fleming added that the pace of change was the biggest challenge for a treasurer involved in a private equity deal.

"You have to do whatever is required and won't have the opportunity to embellish with anything that doesn't add value," he said. "Over-analysis doesn't work in this environment because it's simply too pacy."

WHAT ABOUT TREASURY? Although the areas of potential treasury involvement in private equity acquisitions would vary from one business to another, said Stebbings, treasury was likely to be impacted not just on the change of ownership but also early in the deal process and post-deal. The initial – or "identifying deals" – stage, which will preclude treasury involvement, will include a strategy review, the finalisation of acquisition criteria and the identification and screening of targets by the private equity group.

The subsequent stages, all of which have the potential for treasury involvement are as follows:

Evaluating the deal
- approaching the target;
- valuation and synergies;
- tax structuring;
- deal structuring; and
- integration planning.

Executing the deal
- due diligence (financial/market/operations/legal/tax);
- negotiation;
- finalising the structure; and
- finalising the sale and purchase agreement.

Harvesting the deal
- post-deal integration; and
- adding value to the business (for example, by rationalisation).

All these areas of activity helped to make treasurer more rounded executives and brought many of them out of their ivory tower, said Stebbings, but warned: "If debt financing is your main focus, then private equity probably isn't for you."

He pointed out that the rationale behind private equity was to pick out the areas of a business that represent real value and, ultimately, to make a sale.

"The methods involved can sometimes be controversial," Stebbings said. "For the treasurer it raises the profile of debt, but he or she can also raise their own profile, provided they grasp the opportunities."

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The pros and cons

WHAT ARE THE PROSPECTS FOR PRIVATE EQUITY DEALS AND THE TREASURER'S ROLE POST-DEAL, IN 2008?

The conference message was strongly positive and can be summarised as follows:

- The credit crunch has sparked a greater focus on the treasurer's skills and should be regarded as a great opportunity. The role will become more strategic and less tactical, so treasurers must consider the implications of the treasury function on what other employees are doing.
- Treasurers have an enormous impact on value as they move up the financial supply chain. One of their main roles is to co-ordinate the advice from various parties and to manage change, leading to their deep involvement in the business.
- Cash is king, so the treasurer rules in a centralised world. But the king must run the kingdom effectively and report to his subjects on a regular basis. Weekly cashflow forecasts, for example, remove the potential embarrassment of the figures not adding up.
- The increased pace and alignment that private equity brings to a company means that the position of treasurer under private equity is not one for the fainthearted.

But critics of private equity argue that its effect on acquired business is too often detrimental, while the role of the treasurer risks being devalued rather than enhanced. Their criticisms include the following:

- Private equity's policy of squeezing value from an acquired company by maximising debt and disposing of assets that don't provide adequate returns creates vast amounts of extra risk. If the business fails to meet its targets by even a small margin, it may be unable to service debt.
- Private equity is ruled by the short term. As it aims to sell the company within three to five years, the focus is solely on those activities that meet with this strategy and anything that fails to add to equity value is ignored or abandoned.
- The private equity house actually harms a treasurer's status, by taking over a large part of their corporate finance role, such as negotiating loans. Treasurers will still be involved, but to a lesser degree.
- The structure of debt restricts the treasurer's options for local banking services. If a bank isn't a member of the loan syndicate, then continuing to use it is problematic. Moreover, a bank that isn't already part of the syndicate will be unwilling to lend money to the company – a situation that has got worse since the onset of the credit crunch.

High leveraging means that the banks require security in the form of the company's assets. This is a lengthy and expensive process, with high legal costs, and results in a series of security pledges, all of which come with their own terms and conditions and all of which have then to be monitored.