Cold comfort

PRIVATE EQUITY BOSS AND ACT ANNUAL CONFERENCE KEYNOTE SPEAKER JON MOULTON SAW RECESSION LOOMING WHEN THE PARTY WAS STILL IN FULL SWING. THE RESULTING HANGOVER WILL BE LONG AND PAINFUL, HE WARNS **GRAHAM BUCK**.

PHOTOGRAPHER: ROGER HARRIS

In 1997 the Labour party returned to power after a prolonged period out of office and Jon Moulton set up his private equity vehicle Alchemy Partners, which is perhaps best known as the potential rescuer of Rover at the start of the decade. Alchemy has invested nearly £2bn since it was formed and has developed a reputation for rescuing troubled companies. However, the medicine Moulton was proposing for the car maker a decade ago proved unpalatable for the unions, which, at the time, were relieved by Alchemy's failure to strike a deal with Rover's owner BMW.

Moulton believes that while his ambitions for the Rover group were limited, the car maker would probably still be in business if the Alchemy plan had won acceptance. "Although if we hadn't sold it by now, that would have meant there was a problem," he adds.

The future that Moulton proposed for Rover back in 1997 involved scaling down its activities and refocusing the group as a small sports car manufacturing business.

Almost a decade later, many of Rover's problems are shared by the biggest names in motor manufacturing and taxpayers have borne the cost of a series of reports on the future of the UK car industry. Is Alchemy talking to other firms as a potential buyer?

"We've been asked to look at a number of the big names, including Vauxhall, Opel and Saab," Moulton confirms. "Unfortunately, in every case they are both too big and in too sick a condition for us to take them on; Rover was small by comparison."

In addition to being a chartered accountant, Moulton is a Fellow of the Society of Turnaround Professionals and, so says his business card, a CF or Corporate Financier, a recently founded qualification issued by accountancy body ICAEW's Corporate Finance Faculty and promoted by Moulton.

Hence Alchemy's focus on turnaround. It has seen its investments typically return nearly four times the capital put in. In 2006, when Moulton was publicly warning that a flood of capital had created an overheated market that was ready to implode, an Alchemy special opportunities team was set up to take advantage of everything from distressed debt investments to litigation funding.

"We're pleased to be in the position we are at the moment, as the flow of troubled companies has never been greater," Moulton declares. Some in the motor industry might be past redemption, but is more interested in other sectors anyway. "There are certainly deals to be done at the moment in the construction sector and I certainly wouldn't rule out a private equity deal happening."

But the private equity sector itself is also feeling the chill winds of recession. "Half of the capital invested by firms in the private equity industry was put in over a two-year period from early 2005 to early 2007," says Moulton. "Most of that equity is now near-worthless. Unless there is a fairly swift recovery in both equities and the markets, half of these firms will be killed off."

Meanwhile, although there is no shortage of corporate casualties, Alchemy is denied the chance to consider a significant number of opportunities due to the growing use of pre-pack administrations, also known as "quickie bankruptcies", where plans to break up a troubled company are agreed in advance of its eventual demise. The valuable assets are bought out immediately, often by the company's executives, who leave behind the loss-making assets and debt.

Moulton has been highly critical of the practice, which he says is wide open to abuse and of dubious legality, cheating the company's customers and staff as well as its creditors. However, he believes that pre-packs merely postpone the business surgery needed to turn around a company's fortunes. "I suspect, though, that we will get to see them eventually," he adds.

The Alchemy chief's pronouncements on the economic outlook have regularly been more downbeat than prevailing opinion over the last few years. In the boom times he warned that a sharp correction was imminent, and as the credit crunch got under way he was already correctly predicting recession, although he admits that the scale and severity have surpassed even his expectations.

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"Although I hope that my prognosis turns out to be overly pessimistic, I'm still not hopeful about the outlook," he admits. "Rather than any recovery next year, it wouldn't come as a surprise if we were to see a contraction of as much as 6% in GDP.

"The level of government debt is a very major concern and interest rates are likely to have drifted back up to 6% within a couple of years. If debt continues to rise, which seems likely, we can rule out any early prospect of growth returning to the 2%-3% per year norm." And any recovery will be further delayed by the impact on personal wealth, which is being squeezed even harder than GDP.

Moulton sees recovery eventually taking place as the government's policy of printing money begins feeding through into the system and asset prices finally begin to appear cheap enough to tempt buyers. But even then, the green shoots are likely to have a sickly tinge, he reckons. "The UK is vulnerable in lacking both world-class manufacturing and world-class technology. The financial services sector will be weaker and it's difficult to see what else might emerge in the meantime to fill the resulting gap."

Added to these concerns is Moulton's perception that the country is drifting back to a situation last seen in the early 1970s, with very high levels of both public expenditure and debt.

"Talk of 'government policy' implies that the administration has a medium to long-term plan, which it hasn't," he says. "At the moment, the government is reacting by using every single item in its toolbar. This might turn out to be a reasonably satisfactory short-term solution but doesn't address longer-term problems.

"Gordon Brown appears not to have ruled out his chances of being re-elected, which unfortunately means that he is looking to minimise the short-term pain. Frankly, that's a policy that verges on the immoral as it puts off the bill to tomorrow and places the debt burden on future generations."

But the need to focus on longer-term solutions will inevitably mean tackling some thorny issues. Whichever party wins in 2010, the next government will have to tackle public expenditure vigorously, and that will inevitably put back the date when the country finally climbs out of recession.

Moulton warns that cutting expenditure down to size will inevitably put the government on a collision course with the public sector unions. As he points out, the public sector is a major employer, accounting for 50% of the workforce in many regions where private industry is puny by comparison.

"Admittedly, life wasn't a great deal of fun when Margaret Thatcher was in charge, but she had the right idea," Moulton adds. And with the prospect of renewed labour disputes comes a possible replay of the social unrest that marked much of the 1980s.

"What was one of the Conservative government's first moves when it took office 30 years ago?" asks Moulton. "It was to award a large pay rise for the police and to step up a recruitment drive, basically because it was well aware of a looming period of social unrest.

"We should expect a repeat. Indeed, the French government is already steeling itself for a period of unrest and we're seeing the first stirrings here with the attack on Sir Fred Goodwin's home. There will be a serious backlash against the rich." This more unsettled social backdrop could further delay the prospects of recovery, he suggests.

BLEAK SCENARIOS While bodies such as the IMF predict a particularly deep and prolonged recession for the UK, the Alchemy chief outlines two likely – and equally bleak – scenarios for the world economy over the next few years. Speaking a few days before the G20 meeting in London got under way, he held out no great hopes for the summit as there would be "too many competing agendas on the table".

Scenario one is for a "global Japan", with many of the world's major economies experiencing the low-to-zero growth and deflationary spiral that afflicted the world's second-largest economy after 1989. Scenario two is for a "global Zimbabwe", in which inflation returns with a vengeance and countries willingly allow their currencies to depreciate so they can retain their competitiveness.

"Both are rather more likely than a return to the relatively benign conditions we enjoyed around 2004," says Moulton. "The world has become massively more unstable."

Already, Japan has seen its exports nearly halve while China has suffered a 20% export drop and will, Moulton predicts, intervene to prevent the value of its currency remaining high. And with much talk in the West of quantitative easing, it has been less remarked on that China has been following the same policy for around six years.

Does he foresee a possibility that government action to support the banks may ultimately prove relatively successful, as it was in Sweden in the early 1990s?

"Well, there is a difference in that Sweden quite openly nationalised its banks, whereas we're trying to pretend we haven't, even though that's what happened," he replies.

"Also, Sweden managed to recover fairly quickly as the government was able to convince the populace that it had got public spending under control. This encouraged consumers to begin spending again. Consumer confidence very much influences both recession and recovery." The implication is that curbing the UK government's spending tendencies will take rather longer.

Moulton has previously forecast that banks will restrict themselves to plain vanilla business in future, principally loans and savings. "Simple banks, which can be regulated better than before, should and will emerge, he says, although there will still be a need for some of the more exotic products that caused them to stumble.

"Some of them we could happily live without, but a number of the derivative products fulfilled a legitimate need so we could see them offered either by the investment banks or in a more regulated hedge fund world," he adds.

But it is important to have entities that can actually be regulated. He says that the US insurer AIG offers a prime example of "an entity that became impossible to regulate, mainly because it was too difficult to fully understand the areas that it had got itself into".

Despite the importance he places on regulatory activity, Moulton fears that we are moving into a period of overregulation. "The likelihood is that we will have regulatory overkill over the next few years," he predicts.

Indeed, Financial Services Authority chief Hector Sants said in March that the organisation's staffing would rise by 30% this year as it toughened up its policy, and the US financial regulator the Securities and Exchange Commission has indicated that tighter regulation lies ahead for the hedge fund industry.

"We will then be faced with the task of peeling back the excesses, which will be a slow and difficult process," says Moulton

So what actions would he recommend to corporate treasurers in these difficult times?

"They basically have two options: they can either place their deposits in countries that they trust, or they can opt to be a little racier with their investments in the hope of a better return. They should take a considered view on what they see as likely to happen to inflation over the next few years and what will happen to currencies."

But he admits that there is little prospect of this work commanding greater attention. "Treasurers will probably have to work rather harder for a living over the next few years, and will also be faced with rather less secure tenures," says Moulton. "Unfortunately, there won't be that much of an upside; for example, they probably won't get the credit if an unexpected profit arrives."

Has he got any crumbs of comfort to offer? "There is one benefit of the downturn: they won't have quite so many silly products dangled in front of them in future."

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