A house divided

ACTIVITY AND OPTIMISM ARE HOLDING UP IN THE WORLD OF UK PRIVATE EQUITY. **PETER WILLIAMS** REVIEWS THE LATEST SURVEY INFORMATION.

While deal-making has not returned to the dizzy heights seen in 2007 there seems to be enough activity to fuel optimism in the market. Management buyout data from accountancy giant KPMG for the second quarter of 2010 shows a surge of consumer-facing deals: making up 42% of deal volume in the quarter. Overall deal activity levelled compared with 2Q 2009 and KPMG predicts another quarter of the same.

Corporate finance advisory firm Corbett Keeling cuts the market into larger UK buy-outs, €150m enterprise value or above, buy-outs of less than €150m, and early-stage/expansion capital deals. Its analysis finds that at the larger UK buy-out end, after just two quarters of 2010, the total number and aggregate value is ahead of the total for the whole of 2009. Up to the end of June, 16 deals had been completed compared with 10 for all of 2009. In value terms transactions worth €6bn have already been completed in 2010, compared with €5bn over the whole of 2009. Corbett Keeling says: "Larger deal-makers can continue to take solace that the drought of 2009 seems to be over."

The drought for smaller UK buy-outs was never as severe as for their larger cousins, according to Corbett Keeling, but the recovery has been comparatively more modest. At €1.4bn deals in 2010 have almost reached 2009's €1.5bn, while volume has increased to 34 completed transactions versus 29 in the same period in 2009.

A similar pattern is emerging in early stage and expansion capital deals: €1bn of deals in the first half of 2010, compared with €1.2bn for all of 2009 and the deal numbers hit the 100 mark exactly in the first half of 2010 compared with 87 in the first half of 2009.

KPMG describes the high level of private equity transaction activity in consumer-facing businesses as "at first glance counter-intuitive". Especially as in more benign times private equity shied away from the high working capital requirements and low margins typical of retail.

Michael McDonagh, KPMG private equity partner, says: "One would have expected this sentiment to be exacerbated by the economic downturn's effects on consumer confidence, particularly with newly announced austerity measures. However, the crucial attractive factor in many consumer-facing businesses is that they have a predictable growth trajectory. If a business can be expanded by 20 stores, the growth potential is readily understandable; even if like-for-like sales are tough to drive forward." Budget retailers in particular have attracted private equity, as well as consumer businesses with a market-leading product.

The other trend noted by KPMG is the low risk appetite of the market: the vast majority of recent private equity deals have been typified by high prices for high-quality business. A small number of distressed businesses have also changed hands in recent months.

HARSH REALITIES There is a reluctance from both private equity firms and their advisers to speak on the record about their individual circumstances. Some firms have suffered in the recession and have seen restructuring, often with the bank left owning the company, or a large chunk of it, after the private equity investor walked away with nothing more than a hefty write-off.

For businesses that have survived without a major financial re-engineering, and with active investors and good prospects, the messages are all about continued deleverage, an unwavering focus on cash and an acceptance that private equity is no longer just a short-term game. There is an acceptance that exit strategies are being built on longer-term horizons.

An industry expert told The Treasurer that private equity is currently "a strange market". Good-quality assets are still selling at multiples of 12 times or more, terms that would have been recognisable back at the peak of the market in 2007.

The other significant element about the current market is the lack of gearing. Rarely will you see deals with debt above 50% of the value of the deal and in some cases no debt is involved at all.

For those companies backed by private equity in 2007 and 2008 there is an unending emphasis on cash and strong working capital. Even those companies that avoid trouble will in many cases see big repayments in 2012 and 2013.

For those with stakes in lower-quality assets, where the price has fallen or where banks have become majority shareholders, it is a question of hanging on until a more palatable multiple emerges. With low interest rates there is a low number of distressed assets but a rise in interest rates could trigger a whole new chapter in the private equity story.

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