



## Newsletter Autumn 2009



### ► Welcome to the recovery?

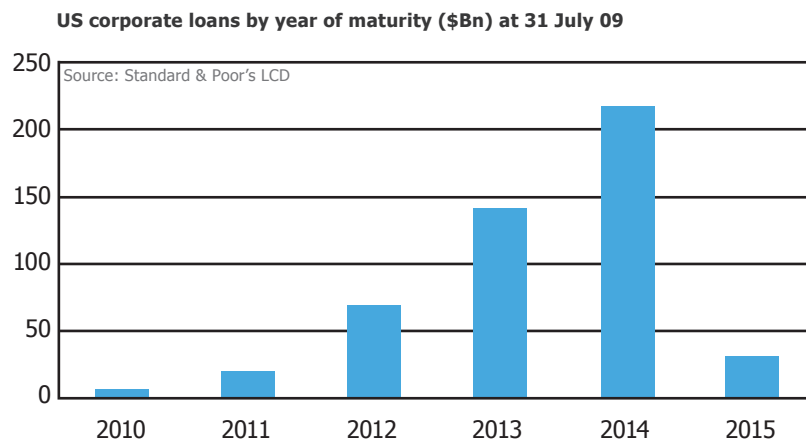
Recent data from France, Germany and Japan showed that these economies grew in the second quarter of 2009 after four quarters of decline. There is also evidence that the US economy is bottoming out, suggesting that the worst is now behind us. This return to growth however has been driven in large part by government stimulus packages; as these are progressively withdrawn, the challenge will be whether the private sector will be able to fill the gap.

The outlook for corporate earnings growth remains poor. With unemployment forecast to continue to increase in most major economies, it is hard to see consumer spending increasing substantially, particularly in the US and UK where there remain substantial pressures to reduce personal indebtedness.

**We believe that no sustainable recovery can occur unless major western countries restore the health of their banking systems. Unprecedented government intervention over the last 12 months has brought some stability to the financial sector; the next step is to rebuild the banks' balance sheets. Bad debts will continue to mount as previously sound businesses are dragged down by the length and depth of the recession. A reluctance to mark assets to market will create continuing uncertainty. Finally, the need to improve capital ratios will also result in banks' balance sheets shrinking.**

Given these dynamics, new lending is only available to the best of credits, and then on terms that are eye watering expensive when compared with those available two years ago. Terms on existing facilities are tightened at any available opportunity. Faced with this environment, borrowers are highly incentivised to repay debt, and for highly leveraged corporations, the job has only just begun.

Much of the debt raised to finance the buyout boom of the middle of the decade matures over the 5 years to 2014 (see chart). Many of these companies are already struggling to meet covenant tests on this debt due to difficult trading conditions. Even for those businesses with minimal debt covenants, existing cash flow will often not be sufficient to meet repayment schedules.



The result is that the substantial majority of these LBO's are likely to have to reschedule debt; the question is when and on what terms. For equity holders in these companies, the outcome of these negotiations will determine the ongoing value of their investment. If existing stakeholders cannot find additional cash to invest, their negotiating position is weak. Investments not financed with excessive cheap debt will find it easier to survive in today's conditions.

M&A markets remain subdued through a combination of the lack of available credit and the uncertain environment for profits. As always, top quality assets remain in demand as investors with capital continue to seek out the very best opportunities. Elsewhere, however, sale prices have still not fallen to a level which reflects the increased return on capital that investors and lenders are demanding. This gap in expectations between buyers and sellers means that few transactions are completing. This gap will only narrow once the economic outlook and implications for underlying levels of profitability become clearer.



► **Strategic Options for Private Equity Investors**

We are in the middle of a major dislocation in the markets in which private equity operates. Changes in valuation policies, the drying up of credit markets and economic recession have created substantial uncertainties over the current and prospective values of private equity portfolios. In this environment, most investors have, through either design or necessity, chosen to sit tight to wait and see how things develop. Given that fund cash flows have been broadly neutral, with both drawdowns and distributions at very low levels, this default position has been sustainable in the absence of immediate liquidity issues. As the implications of the new market dynamics become clearer, committed private equity investors should proactively adjust their strategy to capitalise on the new opportunities that will undoubtedly emerge.

The hardest investments to value at the moment are leveraged buyouts completed in the boom years of 2005 – 2007. Most of these investments have debt burdens that are unsustainable today, and will require restructuring. Those deals where restructurings have been announced, such as Samsonite, IMO Car Wash, Four Seasons and Ferretti, give some clues as to potential outcomes. The common thread is that a significant portion of the debt is converted into equity. The ability of the equity holder to retain upside is predicated on both the injection of new funding and the balance of negotiations with the syndicate of debt holders. Where the equity holders have not invested new money, their investment has been effectively written off. The ability to invest further is therefore key to retaining value. For funds that are essentially fully invested, this might require raising a top up or annex fund. The terms of these vehicles, and possible conflicts with the original fund investors, are a potential minefield.

Investors should now be considering carefully the fund strategies that they should adopt over the next cycle. Leverage will not return to any significant degree within this planning scenario; cheap debt has made a substantial contribution to returns for many funds in the past and this will be hard to replace. New investment strategies will be better positioned to benefit from the undoubted opportunities that this new environment will present.

Looking forward, the cash flow of the asset class will be negative, as distributions remain at very low levels, while drawdowns will pick up as M&A transaction volume increases. For many investors this has the potential to create cash flow difficulties which, at best, will preclude commitments to attractive new funds, and at worst could result in defaults on existing commitments. We have seen overcommitted investors taking evasive action to avoid this in recent months. Selling in the secondary market remains an option for investors seeking to proactively manage such situations and, while prices have fallen along with quoted markets generally, it can offer a valuable source of liquidity.

Many market participants talk of a bonanza of opportunities for secondary funds driven by the wide discounts at which fund interests can be acquired and a wave of forced sellers. However, the changes impacting primary investing will also substantially alter the dynamics of investment strategies in the secondary market. Before committing to new secondary funds, investors should make sure they understand the historical performance of these managers, and carefully assess whether or not the continuation of such strategies is likely to deliver the desired returns.

**In spite of press reports to the contrary, the private equity model remains attractive, with the interests of investors and managers closely aligned on a cash-to-cash return basis. However, investors must recognise the fundamental changes that have occurred in all markets, and adjust their private equity investment strategy accordingly. The case for long term private equity outperformance remains as strong as ever, but history tells us that the key to achieving superior returns is to identify top quartile funds. As a result of the fundamental market changes we are now experiencing, the investment strategies which deliver this top quartile performance over the next cycle are likely to be substantially different to those that have succeeded in the past. Now is the time for investors to demonstrate their selection skills in backing the managers and funds of the future.**

## About Hollyport Capital

Hollyport Capital was formerly Newgate CSP Capital, changing its name in June 2009.

Hollyport Capital is a specialist in the private equity secondary market. If you would like to discuss any aspect of your private equity strategy, please contact John Beatty or John Carter (contact details overleaf).