RESILIENCE AND PRIVATE EQUITY

Is resilience relevant to private equity? Yes: over the last 5 years, we have seen businesses either owned by or previously owned by private equity firms collapse. The collapse has usually been caused by the firm running out of cash. In their quest for efficiency and good financial returns private equity firms may sell assets, often selling and leasing-back the properties that are used by the business, or increasing the leverage of the business and making distributions to the PE shareholders. This, so called, financial engineering is an important part of improving the financial performance of target firms and making an acquisition attractive.

Private equity businesses have a role to play in any capitalist society, by:

- consolidating sectors to build sector participants with increasing scale to create a new competitor in the sector;
- reviving a 'zombie' company, by reducing inefficiency (through over-conservative management, overstaffing);
- bringing additional skills to the management team;
- enabling management to create a new business, possibly an innovative one which without private equity (or venture capital) backing might not be brought into existence; and
- being patient investors;

This often adds value and provides a valuable service to the individual business and to society as a whole. We believe that it is also right that PE firms should extract reasonable amounts of cash from the investee companies, for that is the point of business, but the extraction must be reasonable and commensurate with the value-added, not excessive.

Most PE Houses are good at the key aspects of creating a resilient business:

1. designing resilience into the transaction, and into the industrial strategy if the PE house is planning the consolidation of a sector;
2. having a resilience plan, focussing people's minds on the key issues in ensuring that once the transaction is completed that there is a base plan for the business. The plan is important, but the planning is more important!
3. scenario planning with financial projections showing the financial outcomes in a variety of scenarios, and demonstrating the ability of the business to survive (and prosper) in a number of scenarios;
4. prepared to invest where the financial projections show that it is necessary; and
5. ensuring that the plan is understood by the staff;

The link between private equity investment and resilience is that in a few recent cases the private equity investor has extracted so much value from the acquisition and disposed of the business in a state that it is no longer resilient, hence its subsequent collapse. Sadly there are all too many cases of lack of investment in R&D and marketing, aggressive sale and lease back deals or overly burdensome debt arrangements.

This process should ensure that if the private equity owner divests the business, the new owner should take over a sound business.

If after a relatively short time the business fails, the whole process has been a waste of time and money – there is little point in a private equity firm investing if they don't create a resilient and, therefore, lasting business. Not only is this financially uncomfortable for the private equity firm, it also damages the reputation of the firm and of the private equity industry as a whole.

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