

Leading the way
Insights for Canadian
private equity



A bright future in 20 years' time?

Guy Hands says the contraction in credit availability to business and subsequent inappropriate government actions could end up destroying western competitiveness, but private equity should emerge a better managed asset class.



Guy Hands is well known for plain speaking. So when the former Nomura head of private equity and chief executive of Terra Firma, a leading global private equity firm, opines that the current downturn is “as dramatic” as that in the 1930s, you know it’s bad out there. “Massive risk still exists within the system and, even after last year’s bailout, it is not clear how banks will rebuild earnings,” he says. Taking banks’ assets onto national balance sheets, while side-stepping the immediate risk of systemic collapse, creates other risks. “It will cause enormous problems down the line. There is a clear destruction of the free market economy going on and this will affect western competitiveness and broader social and economic freedoms. Governments say they are enacting short-term emergency measures, but it is impossible to know how long they will last. I can only view the new economic reality as very negative for western competitiveness over the long term.”

“Debt will not return to the levels of 2006-07 in our lifetimes.”

Strong sentiments from a serial deal-maker of the past two decades. “The coming banking crisis was clear by August 2007,” says Hands. “We were trying to discuss with Citi how to syndicate the EMI deal and it became obvious that Citi did not have the capital base to hold such loans comfortably on its balance sheet.”

Hands made the decision then not to chase any further deals aggressively until the market started to correctly price the effects of the credit crunch.

Since then, debt has dried up to the extent that traditional private equity activity has been virtually impossible, except for selected deals primarily in the mid-market. Hands believes a process of 30-40% global deleveraging is underway. “Debt will not return to the levels of 2006-07 in our lifetimes,” he says. There will be 25% less debt in future deals, he thinks, and multiples of debt to EBITDA will fall by a third from their peak.

His predictions are – if they prove accurate – shattering. The private equity industry will shrink to just a quarter of the size of projections made for it in 2007 and 2008. Where a firm predicted it would manage \$200bn in assets by 2012, Hands believes that should be revised to \$50bn.

Naturally, such a contraction would imply many fewer jobs. “A lot of private equity firms are starting to lay people off,” Hands says.

He stands by a statement he made in Paris at the end of 2008: “90% of industry players are not money-makers,” he says. “Just 10% make the difference to whether an investment makes money or not, and in boom times their abilities are leveraged up. But in bear markets, those employed will be reduced to bring firms closer to the 10% of ‘money-makers’.” He believes

firms will end up with a ratio closer to 30% money-makers, meaning the industry will need to shed about two-thirds of those directly employed in it. Evidence that this 'clearing out' has already begun includes announcements of job cuts by a number of private equity houses, including at 3i, Carlyle, Blackstone and indeed Terra Firma.

“Those who played the game hard and to the limit may not be the right people going forward.”

Canadian private equity firms, having operated with “leaner” investment teams, are not likely to see the same level of contraction. However, we can expect to see fewer firms successfully able to raise successive funds as good performance in this market becomes more challenging.

Despite the difficulties the industry faces, Hands is more sanguine about the future than he was last year. It coincides with Terra Firma’s renewed interest in potential deals. “We have just started seeing attractive deals again for the first time since EMI,” Hands says. Despite the lack of leverage, he believes good returns can be made with little or no debt. And alternative debt-providers may step forward this year to oil the wheels. “Sovereign wealth funds (SWF) and pension funds are moving into providing direct quasi debt-like instruments,” he says. But SWFs are not a panacea for private equity’s ills, he admits. “The global banking system was – and still is – enormous. Will SWFs provide debt and structured debt for deals? Yes. Will they replace banks? No.”

Despite the lack of debt, or perhaps because of it, Hands sees a better private equity industry in the future. “Things will get better, but it could be three, seven or 20 years until they do. I’m hopeful it will only be three years.”

“The private equity industry will be more aligned with its investors and less focused on raising money. It will be in less of a hurry to earn fees and more determined to create sustainable long-term wealth.”

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Positioning for positive returns

On a global level, private equity firms have a long time to wait before they see sustainable performance improvement according to predictions made by Guy Hands. But in Canada, perhaps the wait won't be that long.

Mark Jamrozinski, co-chair and Scott Foster, partner of Deloitte's private equity practice acknowledge current market indicators are far from rosy. Deal activity in Canada's private equity sector dried up in late 2008 and has yet to reemerge. Access to liquidity remains a challenge in terms of the conditions being imposed and overall availability of capital. On the bright side, the Canadian private equity landscape is primarily mid-market focused, which tends to be somewhat less competitive than the global mega-buyout market that Guy Hands referred to. Jamrozinski and Foster believe that for private equity firms to excel in the Canadian environment, they will need to rely on four key drivers of return:

- Proprietary deal flow
- Industry specialization
- Operational capabilities
- Focused and comprehensive due diligence

"Proprietary deal flow, encompassing a creative market thesis, deep relationships within and surrounding an industry and a profound understanding of the drivers of a specific market area, is essential for funds to drive exceptional returns," says Jamrozinski.

The focus on operational capabilities will take different shapes depending on the scale and resources of a fund. Many funds will bring this expertise in-house, while others will need to develop and nurture partnerships with executives and other partners to ensure they have the necessary competencies to provide value to their portfolio of companies.

Along with the change in how deals are created, the way that private equity firms approach due diligence has changed. Increased time and effort is needed to deal with the increasingly complex issues when doing deals. Volatility in commodity prices and foreign exchange rates, along with other factors, make it very difficult to determine the appropriate value and mitigate risk.

"With the desire to mitigate and shift risk exposure, funds will look to evolve the deal structure to encompass many tools abandoned over the past few years," says Foster. "The reemergence of vendor take backs and earn-outs will help shift risk to the seller and facilitate the financing of transactions."

We may also see instances where funds will look to diversify risk with other financial backers by partnering with industry focused funds or those with strong operations capabilities. Many funds have opened their minds to making minority investments and PIPEs. With deflated valuations, these alternatives are often far more palatable for vendors and provide interesting opportunities for private equity funds hungry for interesting deals.

The truth is, opportunities still exist in Canada's private equity sector, despite the current contraction. There is still a lot of capital that needs to be deployed, even if those funds with money are taking their time before making new investments. As the market corrects itself through the latter half of 2009 and into 2010, private equity firms will find themselves with a unique chance to buy companies that are fairly valued and hold them until they are ready to reap solid returns.

Even amid existing weak conditions, investors that can identify companies with depressed prices relative to their earning potential can position themselves for significant growth over time – particularly if they are willing to take the time necessary to help their portfolio companies grow.

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Big issues

Finding liquidity

2009 opened with global bank balance sheets under intense pressure - this despite public and private markets raising billions of dollars in new capital and the reduction of interest rates worldwide. Recent monetary easing has done little to improve liquidity and stimulate deal flow.



Despite some flashes of activity, corporate and private equity borrowers continue to report dramatically reduced liquidity, leverage multiples in retreat and deal volumes at historic lows. With bail-out funds in hand, banks continue to record writedowns, with the scale far exceeding anything we have seen in the last 20 years. During the remainder of 2009 and in 2010 the private equity industry will need to develop new funding structures and models to survive in a dramatically changed financial environment.

Russell David, partner and Canadian leader of the Corporate Finance Advisory practice at Deloitte, comments, "The credit crunch is causing lenders to tighten both access to capital and their terms. As a result, the costs of borrowing continue to climb." In the Canadian private equity arena, average senior loan pricing has moved upwards from 225-275 basis points over LIBOR by in excess of 200 basis points across the range. Many banks anticipate pricing to continue to increase. The lender landscape has also changed, with a number of major banks shutting down their leveraged finance teams and others moving to reduce headcount.

Bankers who strongly supported private equity-backed transactions, now welcome the return to what they see as a more rational environment, characterized by more sensible lending criteria. Many believe much of the

activity this year will be confined to the mid-market. That said, banks are still leery of underwriting new deals. "At least in the near term, we've entered a new era of conservatism," David says.

The implications of recent market developments are not confined to new private equity investments. By far the biggest impact of the credit crisis may be the consequences for those 2006 and 2007 generation transactions that are now operating with debt structures clearly 'outside of everyone's comfort zone'. By necessity, exit horizons will need to be longer and return expectations may be historically lower. In a dramatically changed economic environment, many investee companies' original business plans look divorced from reality.

Thanks to this new environment, private equity-backed companies are focusing more intently on liquidity management, cash availability and cost reduction. While many companies have reset financial covenants and secured waivers for actual or impending breaches, it will be challenging to achieve a successful restructuring if they require new money. In those cases, insolvency may be likely.

From a private equity perspective, expectations for future debt structures will have a new look. Doug McDonald, a partner in the Corporate Finance practice

at Deloitte notes, “When Canadian private equity activity resumes, a return to more conservative credit practices will be commonplace.” Tighter covenants, lower leverage multiples and increased financing costs will reflect a financing model more focused on credit and lending than the underwriter’s ability to sell the loan in the secondary market.

Many believe that while there will be few \$1 billion plus ‘mega’ buyout deals, conditions are favourable for a return of mid-market activity. McDonald explains: “Public companies that lost a lot of value in the markets in recent months can often make the case that their true value is no longer fairly represented. Private equity firms willing to take new approaches to the market may discover unparalleled investment opportunities.” These may take the form of ‘public to privates’ or the more recently developed private investments in public equities (PIPEs), providing liquidity for growth where debt is no longer readily available or taking debt levels down to levels consistent with current credit restrictions. That said, sustained deal activity is not likely to return until the challenges of the credit crunch have been fully reflected in financial performance. Private equity investors may not be able to fairly value companies until late 2009 or early 2010.

With loan asset prices in the secondary loan market remaining depressed due to oversupply, many firms continue to examine the merits of investing in senior debt within their existing portfolio, as opposed to new deals. A growing number of private equity firms are establishing specialized distressed debt funds. With discounts of 40% to par or greater, the buyer can create significant yields with the potential to acquire the business via a back door through a debt for equity swap.

Opportunities will emerge in certain sectors where private equity will prosper even with greatly reduced debt levels.

Although opportunities exist to make equity-only investments, a wholesale return to deal activity relies on the return of liquidity. Visibility is poor on when this will happen and what will be the trigger. When credit does return, there is no question banks will insist on lower debt multiples, higher margins, more security and tighter covenants, offset by lower asset valuations and valuation multiples. More significantly, private equity firms and lenders will work together to develop new funding structures, whether they be wholly fund facilities to draw from, mezzanine financing or a revised version of the CDO/CLO model.

The upshot? Debt availability will not return to the level private equity experienced over the last four years. 2009 will likely remain very tough and when liquidity does return, the banks will insist on much tighter lending conditions. Private equity returns will need to be made in other ways than just from leverage, such as revenue and margin growth, and cost reductions – both the result of well run organizations operating at a world-class level.

Private Equity deals without debt

In capital structures before the credit crunch, exposure to the companies bought in leveraged buyouts was sliced and diced into many layers. There was senior secured debt at one end of the risk/reward spectrum, equity at the other, and several other capital layers in between. Institutions that invested in private equity funds received a reasonably pure exposure to the equity part of the spectrum, although they also got debt exposure, if desired, by investing in bond markets, debt funds, mezzanine funds and shares in banks.

If there are fewer leveraged buyouts in the future, how will this affect asset allocation strategies of institutional investors and returns for private equity firms?

If a private equity firm buys a company using only equity, the company and its institutional limited partner backers, continue to be exposed to the entire spectrum of risk capital (debt, equity, etc). Given this consequence, institutional investors are more likely to adjust asset allocations and increase their private equity

investments. Yet, at the same time both the private equity funds and their institutional supporters have lost the benefit of leverage in generating what they strive for – outstanding financial returns. To outperform in the future, general partner investors must return to the roots of private equity by growing the enterprise value of portfolio companies through operational improvements and organic growth, rather than cheap leverage and multiple expansion. That is a good thing. Those who do this will become the new best in class performers, returning private equity funds to their previous balance of risk and reward. The result? Even with less debt available for buyouts, private equity has a promising future.

Distressed investment opportunities

Although liquidity challenges plague many firms, private equity funds with the distressed investment mandate and the skill set to get deals done, are well positioned to capitalize on undervalued companies in the marketplace. That said, the hands-on operational turnaround needed in these types of investments requires a specialist approach, and style drift in this direction by generalist funds may not be well received by limited partner investors.

Economic weakness and restricted credit across most sectors and markets is causing a huge increase in distressed investing opportunities. The number of opportunities coming across the desk far exceeds the number of deals actually getting done.

Assessing execution certainty early in the game – including target viability, existing capital structure, company management and existing stakeholder expectations – quickly pinpoints real opportunities.

Make the most of distressed investment opportunities

- **Determine the source of distress**

The source of distress materially affects the suitability and nature of the investment opportunity. Sources of distress can include: being overleveraged, having a distressed stakeholder, experiencing deteriorating industry conditions, losing a key customer or supplier, undergoing litigation or labour disputes, or suffering from poor operational practices or execution

- **Assemble an experienced buyout team**

Distressed buyouts require speed of execution in an uncertain environment, as well as the resources to understand and turn operations around

- **Develop a strong financial and operational plan**

Lack of earnings visibility makes it important to develop a thorough financial and operational plan grounded in a comprehensive understanding of past performance and future value drivers

- **Assess all stakeholders**

Successful transactions often hinge on gaining a complete understanding of what motivates key vendor stakeholders

- **Carefully structure the transaction**

To bridge value expectations, engage in flexible transaction structuring that considers how buyers and vendors might share material post-transaction risks

- **Understand the implications of both formal and informal restructuring**

Insolvency laws around the world differ widely and their practical application can significantly affect the ability to conduct deals

- **Engage in active management**

Recognize that you will likely require ongoing restructuring and operational expertise throughout the investment cycle

- **Stay flexible**

Turnarounds and special situations are not suited to every fund and require an operational alignment different from traditional private equity to be successful

Big issues

The shifting balance of power between

private equity & institutional investors



The wall of money towering over every fund launch until the summer of 2008 skewed the balance of power in favour of private equity firms.

If investing in successive funds could be considered an honour, institutional investors wore that badge proudly. Lured by regular and sizeable distributions, it's no surprise institutions felt obliged to keep subscribing to the next fund. If they spent less time than desirable on due diligence and pushed the issue of fees aside, their actions seem to have been warranted by the times.

According to Coller Capital's Winter 2008/09 Global Private Equity Barometer, little has changed: With expectations of earning net annual returns of 16%-plus over the next three to five years, 57% of institutional investors expected to maintain, and 40% to increase, their percentage allocations to private equity over the ensuing 12 months.

But it is far from clear if investor faith in the abilities of private equity firms is justified. Here's why:

- Returns may decline in the months and years ahead. Current tough trading conditions are depressing portfolio valuations, although there are varying views as to the extent of devaluation. At the beginning of 2009, net asset values (NAVs) in the secondary market were at an approximate 40% discount to values reported by firms. Although the discrepancy may be due to the need for liquidity, it is widely believed that firms have been slower or more reluctant to adjust valuations. In the longer term, less leverage and multiple arbitrage may well lower returns unless private equity firms modify their investment model.
- Although firms may benefit by fundamentally transforming their businesses, it remains unclear whether private equity players can become growth

capital specialists, emerging market investors or distressed asset investors in short order.

- With faltering returns, some private equity firms risk losing key dealmakers, who may defect to competitors, set up their own firms or leave the industry entirely. This prospect is likely to sound alarm bells among institutional investors who usually invest based on the expertise of the firm's team.

So private equity firms would seem to be losing favour – and the trend threatens to accelerate as the entire industry continues to come under pressure. For their part, investors suffered doubly from losses on their quoted portfolios and from reduced cash flow from private equity distributions. This has led some to sever deals with firms that cannot honour their commitments because of funding shortages. "During these hyper sensitive times, institutional investors are more likely to evaluate the underlying character and integrity of their fund partners," says Mark Jamrozinski, co-chair of Deloitte's Canadian private equity practice. "For this reason, funds have to err on the side of increased open and transparent disclosure to their institutional investors."

Despite a strong appetite for private equity, many institutional investors are now over-allocated to private equity as a proportion of their entire portfolio and must stop allocating to the asset class or even sell existing investments. An indicator of this is increased activity in the secondary markets, although with the amount of assets on offer, investors are being forced to accept significant discounts to exit successfully.

So, is the delicate balance within the industry really shifting or will the status quo – the dominance of private equity firms – survive? The answer, probably, is neither.

This all means that raising new funds – and continuing the virtuous circle that has benefited both institutional and private equity investors – has become much harder. Indeed, precious few funds were raised last year. Robert Olsen, North American leader of Deloitte's Capital Advisory practice, comments, "The mismatch between firms wanting to raise new funds and the lack of supply from institutional investors will not likely improve until 2010 and, even then, earlier stage funds and any fund without superior returns will struggle to raise new capital."

But since many private equity firms have significant amounts still to invest from 2007-08 funds, and resources are focused on preserving value in the existing portfolio, fundraising is generally less of a priority at present. As well, amid the general turmoil, institutions are likely to place greater demands on firms. They will seek improvements in the information they receive about the performance of the portfolio, as well as better governance. There is already evidence that institutions are gaining influence, with greater powers accruing to advisory boards.

Pressure is also being exerted on fund sizes that have been on an upward trajectory for many years. These types of demands will likely apply to all but the top-performing funds, which will still be able to dictate terms and conditions. The rest could be forced to make some uncomfortable concessions to their investors. After all, Global Private Equity Barometer notes that four out of five North American private equity investors refused to reinvest with one or more of their existing firms over the last 12 months.

It is also possible there will be a genuine debate around fees, just as there is in the hedge fund sector. The discord centres not on the fee percentage, where a number of the larger buyout funds have already reduced management fees to 1.5% or even 1.25%, but on the lack of visibility and accountability around fees. Helen Steers, head of European Primary Investments at Pantheon Ventures, says there was always room for negotiation over fees, but now there is more. "Institutional investors need to be mature and look at the whole package, including at what the managers need to run their businesses successfully. It is all about alignment of interests," she says.

Despite the best efforts of organizations such as the Institutional Limited Partner Association, each investor acts in its own best interests. So, is the delicate balance within the industry really shifting or will the status quo – the dominance of private equity firms – survive? The answer, probably, is neither.

Olsen adds, "Regardless of where terms and conditions end up for new funds, institutions now have an opportunity to rebalance their asset portfolios and possibly shift away from the more traditional buyout funds to ones which offer more attractive returns in the current environment."

The landscape has changed, possibly forever, and it has altered for the whole industry. There are no longer obvious winners. The most likely scenario is that institutions and funds will both endure a torrid time – at least in the short to medium term – and they will have to co-operate and make compromises to survive. There may well be some that do not.

Tax matters: Plan for future growth

“In a time where cash is king and many private equity funds are working with portfolio companies to improve efficiency, proactive tax planning can potentially boost the cash position of companies and support the financing or refinancing of key initiatives,” says Gary Gluckman, a partner in the Mergers and Acquisitions Tax practice at Deloitte.

Conversely, ineffective or passive tax planning may result in accelerating tax obligations or leaving tax overpayments on deposit and unable to be accessed.

Given the negative implications of ineffective tax planning, private equity firms must examine ways to materially improve their portfolio companies' tax position. Here are some strategies:

Carefully time tax payments

Historically, profitable companies did not worry about accelerating deductible expenses and deferring taxable income as effective tax rates generally were not affected. By accelerating the timing of deductions to delay tax payments as much as possible, companies can conserve cash in these uncertain times. Companies anticipating a net operating loss may even be able to increase the amount available for carry back to recover prior period taxes. Those with net deferred tax assets in Canada and other jurisdictions have to consider the implications of any tax rate proposals that may be introduced. If corporate tax rates are reduced, the value of deferred tax assets may be diminished.

Claim all tax credits and incentives

Any portfolio company that analyzes products or processes with an eye to improvement is a potential candidate for Scientific Research & Experimental Development (SR&ED) tax credits. R&D is not just about scientists in lab coats. Consider the shop floor as a way to broaden your view of R&D. Did employees discover a new way of doing things that required the company to do some re-tooling? Is the company using software that had to be tailored to support their innovation? Also, Canada just introduced new SR&ED claim forms. Consider getting assistance compiling the necessary information to maximize claims.

Recover all indirect taxes

Indirect tax refunds – on GST, PST, HST, fuel taxes, federal excise taxes, customs and duties, or workers compensation – can be processed while a project is still in progress. Companies can get cash back within as little as 30 days after beginning a project. Even if an outside service provider has done a review of prior years, a second “sweep” from a different firm often uncovers additional refunds.

Examine global cash repatriation options

For large, Canadian-based global companies, foreign operating subsidiaries may have accumulated significant amounts of cash. Repatriating it to Canada generally results in foreign withholding taxes, and possibly additional Canadian tax, but opportunities exist to lend the cash. This cash can help meet liquidity needs in the current credit crunch, which is why companies must be sufficiently nimble to act quickly.

Consider restructuring

Often, acquisitions create cumbersome or tax inefficient corporate structures. With depressed valuations for businesses right now, a unique opportunity may exist to undertake a reorganization without concern for triggering gains.

Answer key questions before seeking additional financing or re-financing existing debt

Tax considerations also arise if your portfolio requires additional financing or needs to re-finance existing third party or private equity fund debt that was used to finance the acquisition of the company. In these cases, it's important to answer the following questions:

- **Is there liquidity** in the credit markets to re-finance existing debt?
- **Does the portfolio company** have the ability to obtain third party financing?
- **Can your fund** acquire third party debt at a discount from the face amount of the debt?
- **Will you need** to inject more capital or debt into the portfolio company?
- **Does the portfolio company** need additional tax deductions from the interest paid on the debt or should it be equity financed?
- **In what currency** is the debt denominated and is there a corresponding foreign currency exposure?

All these questions raise several underlying tax and structuring issues, such as deductibility of the interest associated with the financing, debt forgiveness and foreign currency considerations. It is important to anticipate these issues and potential opportunities associated with financing a portfolio company.

Adopt tax management best practices

Effective tax planning can potentially lower overall taxes and free up cash for investment. During downturns, tax planning is often set aside as companies focus on tax reporting, compliance and risk management. While these areas are important, companies must become proactively involved in the strategic direction of the tax function at this time. Challenge your portfolio companies to improve operations and deliver tax planning opportunities. Determine that knowledgeable tax resources are appropriately deployed to support the types of planning outlined above. Now is the time to leave no stone unturned.

"This may be an ideal time to drive change in the tax organization to support future growth," asserts Nelson Whitmore, a partner in Deloitte's Tax practice. "As with all parts of a company, identify ways to improve tax planning and determine how it will contribute to overall firm strategy. Asking and addressing these issues early in the taxation year may just lead to sound financial and liquidity outcomes."

Big issues

The magic art of portfolio management

The time when private equity firms could buy a company, leverage up the debt structure and generate three times their investment in short order are over. The non-availability of debt, combined with tougher trading conditions, derailed growth targets and forced a radical rethink. But moving from a predominantly financial model to becoming expert business managers is a significant step. Can an entire industry reform itself in the timeframe necessary to retain investor confidence?

"To generate the returns of the last few years, private equity has to do things differently."

Ryan Brain, Deloitte

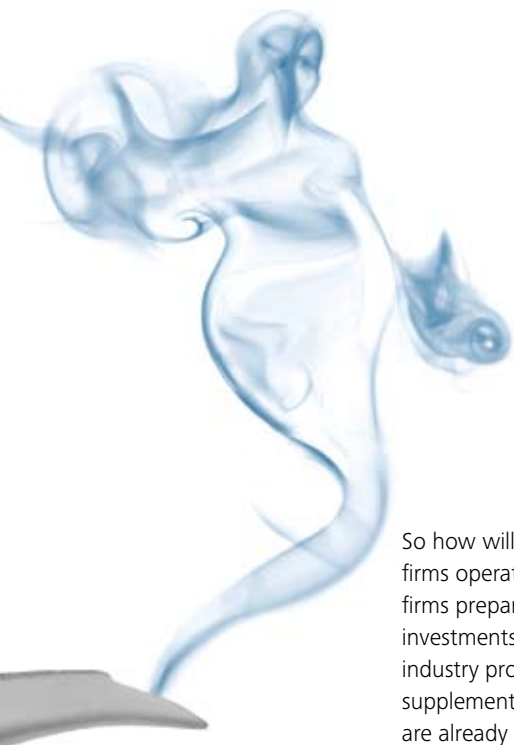


If private equity originally had a 'formula', it looked something like this: Acquire 'under managed' non-core subsidiaries, add management incentives and tighter control, and drive the business harder to realize large profits and cash. In recent years, abundant cheap debt and rising asset prices combined to deliver outstanding returns.

The landscape has changed

The landscape has now changed beyond recognition. Due to high levels of leverage and an anticipated long and deep recession, private equity firms must focus on existing investments. To preserve the value of portfolio companies and maintain control, firms need to drive cash and liquidity, restructure the cost base and provide support to strained management teams to address specific problem areas.

"In the long term, the private equity formula needs to change," says Ryan Brain, a partner in Deloitte's Financial Advisory practice. "To generate the returns of the last few years, private equity has to do things differently. It cannot rely on leverage, multiple arbitrage and a benign economic environment anymore. Put simply, it has to improve the businesses in which it invests."



So how will this new era affect how private equity firms operate? Brain reflects: "Over the past year, many firms prepared their organizations and their portfolio of investments for this new era by bringing in seasoned industry professionals and operational specialists to supplement the traditional MBAs. Those that have not are already suffering the consequences."

Some private equity firms were founded with the intention of focusing predominantly on strategic and operational issues and creating long-term value for their portfolio companies. Expanding the top line, reducing costs and improving efficiencies, can increase profitability in the short term. By strategically developing their portfolio companies, these firms tend to realize higher multiples at exit.

Who's minding the store?

Since September 2008 and the near collapse of the banking system, the need to intervene and support portfolio company management has heightened. But investors should be wary about claims from firms about their 'active' or 'interventionist' capabilities. "Although many firms possess an exceptional ability to spot market opportunities, they often lack the skill to turn inward and mind the performance of their portfolio companies. Predicting a market upswing requires a much different skill set than improving a company's underlying performance," Brain says.

While scouring for new opportunities remains important, firms can't afford to neglect their current investee companies. One way private equity can identify challenges before they escalate is by sharing and analyzing information about companies across their portfolio. By bringing investee companies

together, these CFOs can learn and share information on issues such as working capital, cost reduction and banking relations. For their part, CEOs can discuss how to tackle new markets, integrate acquisitions and organize and motivate staff and board members.

Helping portfolio companies pursue growth is just one side of the equation. In today's economic realities, cash conservation has also become of critical importance. Portfolio companies need to be extremely tight on capital expenditures, without compromising spending on potential growth areas.

And cuts, particularly in numbers of staff, have to be accompanied by judicious leadership. It is a very difficult balance between being tight on headcount and maintaining a happy ship. Company executives need to spend more time on communicating and energizing people to instill confidence in them. It's about leadership, not management.

For private equity firms, finding the balance between intervention and value dilution is a big challenge. If investors turn advice-giving into direction, they are effectively saying they can manage the company better. In that case, they should fire the managers. There cannot be a stable situation if private equity shadows management. It is better off maintaining a position as an intelligent, well-informed sounding board for managers. In this way, investors and investee companies can attain the balance they need to weather and emerge from current economic stress.

Focus on portfolio companies

The current economic climate presents challenges to companies in every sector. For organizations with weak business models, cash conservation has quickly become the prime objective. Even profitable companies are using the economic slowdown as an opportunity to examine their operating models to ensure they're structured to support long-term growth.

These trends highlight the need for private equity firms to support their portfolio companies in their attempts to ride out the market downturn. "The challenge firms face is that their portfolio companies can be at different stages along the growth cycle," explains Peter Brown, National Leader of Deloitte's Private Company Services practice. "As start-ups, they need assistance to create value. If they're facing financial difficulty, they need to protect value. And as mature entities, they need a strategy that allows investors to extract value as part of a planned exit."

By aligning with professionals who understand these divergent needs, private equity firms can help maximize the value of their portfolio companies over the long term. Key areas of focus should include:

Value creation strategies

- Have the right information for the right people at the right time – robust financial and operational reporting and controls support effective performance management
- Remember that the current market conditions may offer opportunities to expand market share or acquire assets at discount asset valuations – though 'buy and build' strategies should have clear strategic and operational benefits. Market leaders gain market share in a downturn economy
- Leverage best practices from companies identified as top performers, including winners of industry awards such as the Deloitte Technology Fast 50™ awards, Canada's Top 40 Under 40, Canada's 50 Best Managed Companies and the Technology Green 15 Award
- Improve performance on a regular basis by identifying areas of underperformance, analyzing available options and adopting strategies to enhance operations
- Evaluate critical market trends and events to help inform decision-making

Value protection strategies

- Where tightening payment and extending credit terms appears difficult, segment customer's suppliers, identifying those that can be stretched without damaging relationships
- Communicate regularly with lenders and other key stakeholders to demonstrate the company's strategy and manage expectations. No news is not good news
- Although large capital projects will be off limits, consider small investments which may improve processes, save time and money and improve profitability
- Cut costs and cut them again – only a small percentage of cost reduction initiatives result in sustainable benefits
- Guard against currency fluctuations impacting top or bottom line. Appropriate hedging strategies can offer visibility and stability, although this is not for the untrained
- Optimize receivables, payables, inventory and other forms of working capital to maintain a strong cash position
- Arrange and structure debt and capital requirements to maximize the value of portfolios, manage risk and improve transparency

Value extraction strategies

- Employ good housekeeping around tax management and tax minimization strategies
- Get advice on how to effectively structure your exit transaction, including conducting comprehensive due diligence and planning for post-transaction integration

"Private equity success ultimately hinges on portfolio company success, which is why firms need to ensure their investee companies have structured their operations to sustain long-term profitability," says Pierre Laporte, leader of Deloitte's Canadian and North American Reorganization Services group. "To accomplish this goal, companies need help to tackle these issues on multiple fronts. This means they must align with specialists who can help them act early to reorganize their operations, strengthen their capital structures, identify opportunities for performance improvement and, if necessary, file for bankruptcy protection as part of a well thought out restructuring plan."



Big issues

Before you invest, investigate

Weak economic conditions do more than expose poor business models. They have a tendency to uncover fraudulent and illegal practices that are easier to hide when times are good. The global markets have been rocked by scandals like the fraud perpetrated by Bernard Madoff Investment Securities. Less showy, but no less dangerous, are the reports of financial statement irregularities cropping up among businesses around the world.

This spate of financial improprieties highlights a critical issue for private equity investors: Without effective investigative due diligence, they may find themselves holding assets with no value and toxic reputational risk. Additionally, by associating with people or entities engaged in unethical or illegal practices, they may be subject to shareholder litigation, civil fines and even criminal penalties.

“When organizations rush to complete deals rapidly, it frequently translates into insufficient levels of due diligence,” says Peter Dent, National Leader of Deloitte’s Forensic and Dispute Services practice. “In a slowing economy, deals that were previously made in haste cannot always be repented at one’s leisure,

particularly where investee companies feel impelled to engage in fraud or take other drastic measures to offset lagging performance.”

Examples of this behavior have already cropped up. According to Dow Jones Newswires, a consortium of private equity firms invested US\$120 million in Chinese sports apparel maker ITAT Group with the hope of a quick exit through a US\$1 billion IPO. That IPO was put on hold amid allegations the company fabricated financial data.

In a similar case, Deloitte was retained by a regional US bank in relation to a planned acquisition of a controlling interest in a regional commercial bank

“Private equity investors need to understand that exposure to high-risk partners and intermediaries can change the economics of the acquisition.”

Peter Dent, Deloitte

in China. “After conducting an anti-money laundering and Foreign Corrupt Practices Act (FCPA) due diligence review, we identified issues of concern related to money laundering, terrorist financing and corrupt practices, such as unusual transactions with consultants, agents and related parties. As a result of this review, the US bank did not go forward with the planned acquisition,” Dent says.

And a good thing, too. Violations of international anti-corruption legislation are punishable by criminal penalties targeting both corporate entities and individuals. For example, the enforcement of the US FCPA legislation has resulted in fines of up to US\$2 billion for corporations and other businesses, while individual infractions by officers, directors, stockholders, employees and agents can incur fines of \$250,000 per occurrence. Closer to home, the risks of fraud, corruption and money laundering also raise the spectre of lengthy and costly investigations that can cripple a company’s reputation and performance.

It’s clear, private equity firms need to know who they’re doing business with. This means conducting investigative due diligence of potential targets and their principals, focusing on:

- The target’s business history and reputation, including previous bankruptcy filings
- Track record of the target’s principals, including their business affiliations
- Sources of capital
- Involvement in litigation
- Central, provincial and local governmental licenses, contracts and political connections
- Conflicts of interest or non-arm’s length transactions
- Side or competing businesses by existing or former employees or stakeholders
- Links to organized crime or illegal activities

“If a deal looks too good to be true, it probably is,” Dent cautions. “In the final analysis, private equity investors need to understand that exposure to high-risk partners and intermediaries raises more than the risk of sanctions. Ultimately, it could also change the economics of the acquisition.”

Do you have the resources to respond to second requests?

Comprehensive due diligence can do more than help private equity firms avoid the risks of fraud. As an industry that engages heavily in mergers and acquisitions, private equity players are particularly vulnerable to Canada’s new merger review process.

Canada’s Competition Act has long supported Section 11 production orders, which allow the Commissioner to request a wide range of data as part of an acquisition that may be subject to anti-competition guidelines. Under a new merger review process, the Competition Bureau can now defer reviewing merger approval applications until after ‘second requests’ for information have been fulfilled. In the US, which has a similar merger review process, it can take six to seven months to comply with these requests, at an average cost of US\$5 million.

By creating a strategy that provides comprehensive data collection, private equity firms can efficiently respond to second requests and production orders. If they are received, a rapid response strategy is also critical to help control the associated delays and costs. With 70% of business information never being printed on paper, companies engaging in transactions need the ability to quickly locate, process, access to relevant electronic information.

The key is to implement transparent and repeatable data production methodologies as part of a best-in-class Analytic and Forensic Technology (AFT) solution. These experienced specialists can assist in identifying, collecting, preserving and analyzing data, including the recovery of deleted e-mails, or damaged, hidden, password-protected or encrypted file data. Leveraging a hosted solution, users can remotely access the collected information and apply data filtering, keyword analysis, deduplication of documents, review documents based on concept threads and mass tag documents thus reducing review times. The result is an auditable process in regards to those documents disclosed to the Competition Bureau.

“Deloitte has the largest and most advanced private AFT facility in Canada that allows us to comprehensively review the available data to deliver relevant export sets to the Competition Bureau,” says David Stewart, National Leader of Deloitte’s Analytic and Forensic Technology practice. “As an added advantage, client data never leaves Canada, reducing the risk of it becoming subject to foreign legislation.”

Interview

Dangers of private equity defaults

Samantha Horn is a partner at Stikeman Elliott LLP and head of their Toronto office Private Equity & Venture Capital group. She is also the current chair of the Private Equity and Venture Capital Committee of the American Bar Association's Business Law Section. In an interview, Horn discusses the dangers of private equity defaults.

How has the current economic environment affected private equity funds?

The market has obviously affected private equity funds, both on the deal side, where there is a lack of good deals and a tight credit market for financing, and on the fundraising side, where the ability to raise funds has been severely constrained. In addition, there seems to be a heightened tendency towards regulation of hedge funds, and some of the changes are likely to affect private equity funds as well.

There have also been issues with defaulting investment funds that are refusing or failing to meet their capital call requirements. As the number of funds in the market drops, we'll see more secondary market transactions – where either the fund's investment portfolio is sold or the fund is merged with another fund. These secondary transactions may also arise where an investor cannot make its capital commitments and instead attempts to sell its interest in the fund.

What's behind institutional investors not meeting their capital calls?

In addition to the general economic conditions, many of the funds (and pension funds in particular) have specific policies for percentages of their funds to be invested in different asset classes. As public markets (and other investments like real estate) fall in

value, the percentage value invested in private equity increases in proportion to their other investments. This is particularly true for funds that have committed capital that has not yet been entirely invested or where the private equity firm has not written down its investments since no market event has occurred. If the capital is committed but not yet invested, it shows as a commitment to that asset class, which is now in excess of the market value of the investments being held in other asset classes. As a result, some of these investors need to reduce their exposure to the private equity asset class. In addition, some investors may have liquidity issues due to the issues with both public markets and markets in other assets classes that have made it more difficult to sell their investments.

And what can private equity firms do about this?

That depends on what the limited partnership agreements say with respect to defaulting investors. Many agreements have what were seen to be quite draconian provisions for defaulting investors – things like an automatic reduction in their capital account, the ability of other investors to buy their interest (at a discount) or to set off the purchase price for the interest against the capital call, or losing the ability to receive distributions going forward. Unfortunately, where the fund did not have a significant number of investments or the investments were not performing well, these measures may not have proven to be as effective as was hoped. Also, private equity firms may be reluctant to enforce these remedies due to the relationship they hope to maintain with their investment partners for future fundraising activities, as well as reputational issues.

Another significant difficulty is that the non-defaulting investors were usually called upon to fill the gap on the defaulting investors' capital call (not to exceed their capital commitment), so this may mean the non-defaulting investors end up with a higher proportionate interest in the fund than they originally bargained for. There has been one case in the US where a firm sued two of its defaulting investors, CapGen Capital Advisors LLC v. Chalice Fund LP and another, filed in Delaware.

A lawsuit like that seems unusual.

Can you describe the circumstances of the case?

A lawsuit like this is unusual, particularly given the fact that most private equity firms want to maintain good relations with their investors. I think it speaks to the level of concern among firms in relation to defaults in capital calls.

Cap Gen issued a capital call with respect to its \$500 million fund. Two of its smaller investors defaulted on their commitments. It is seeking payment of the outstanding capital contributions with interest (plus expenses of the lawsuit) and a court order compelling the investors to make all future capital contributions. Cap Gen has chosen not to exercise the rights it has under the fund documents (including reduction of all or a portion of the defaulting investor's interest in the fund), but instead to sue. The case has not yet been heard at the trial level, but has sent shock waves through the private equity community.

Are there other options for firms in the event of a default?

Some other ideas include having the firm agree to defer making capital calls in exchange for lengthening the commitment period of the fund. This may be a good solution where the firm is not planning to make investments in the near future, given the market and, in particular, the state of the credit markets. Some very large funds have also permitted a limited reduction in capital commitments. Some funds have helped investors access credit lines to fund capital calls or transfer their interests to a third party buyer capable of funding the commitments.

So if you were to predict, what effect do you think these issues will have when people turn to renegotiating the terms of private equity funds?

On the private equity side, I suspect firms will take a hard look at the default provisions, particularly for the "anchor" investors of a fund.

On the institutional side, the key person clauses are going to be particularly important, as are the clauses allowing a certain percentage of the investors to remove the private equity fund without cause. Also, given the fact that secondary transactions are now more likely, investors may try to build in some flexibility to enable a sale of the portfolio or a merger with another fund in certain cases (for example, where a key person event occurs). Investors may also want to closely examine the fund terms with respect to the default provisions and the frequency and accuracy of valuations of the underlying portfolio investments.

Follow the leaders

It's all about perspective and seeing the opportunities for success.

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