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feature

SUCCESSFULLY RECAPITALISING BUSINESSES FROM A PRIVATE EQUITY PERSPECTIVE

10 essential tips from one of Australia's most experienced distressed business investors.

What an amazing two months it has been. The world imploded and by mid-March many insolvency practitioners thought there was going to be a wave of insolvencies starting in April. This did not occur because the government changed the insolvency laws and pumped the economy with over $200 billion.

Consequently, the immediate insolvency crisis has been replaced by a liquidity crisis that will face many Australian businesses over the next six months.

Many practitioners will have clients who will need to address this liquidity problem and will seek to raise capital from a private equity sponsor.

My top tips on recapitalising businesses are as follows.

TIP 1 – BESIDES CAPITAL, WHAT DO YOU WANT FROM YOUR PRIVATE EQUITY PARTNER?

If your client requires rescue capital and wants to remain in the business, then a partnership with a private equity sponsor could be an attractive option.

Deciding what skill sets you require out of 'a private equity partner' should be a key consideration. Some private equity funds have marketing, IT, strategy or other operating partners and these resources can help grow the business faster for the benefit of both the private equity fund and your client.

TIP 2 – WHAT NUMBERS ARE YOU BASING THE RECAPITALISATION ON?

Yogi Berra's famous quote 'Forecasting is very difficult, especially when it involves the future' has never been truer.

There are five major shocks reverberating around the economy:

1. a health crisis
2. a demand shock
3. a supply shock
4. an oil shock
5. a financial shock.

These are offset by massive government intervention. These shocks and solutions will affect every business differently.

Consequently, it is difficult to rely on financial forecasts both as a company director and as an investor. In this environment it is better to present realistic and achievable assumptions. The achievability of the forecasts will be tested during due diligence and a series of optimistic forecasts will lead to questions of the credibility of management.

Instead financial forecasts may be more useful to help you map out scenarios.

Used in a considered way, determining a range of scenarios may help you and your client design a process and understand the range of investment amounts you may require. Additionally, it will assist you engage with investors in a credible way.

TIP 3 – IF YOU ARE TRYING TO RAISE MONEY FOR A CLIENT, HAVE A CLEAR VIEW ON THE COMPANY'S VALUE AND HOW YOU WILL ENGINEER A DEAL

This is the starting point for all private equity firms. What is the value of the business today and what is the potential value of the business in the future?

It is very hard to value a business today given the global uncertainty. Values based on asset value are probably more appropriate if the business is facing liquidity or solvency issues.

A key role for any advisor is to design a process to enable existing equity, financiers and new investors agree upon value.

Knowing in your own mind how you will create the environment to achieve a deal when the stakeholders may have differing views on value is a critical first step. The safe harbour regime helps in this regard, as it creates a timetable. Used effectively, safe harbour will assist a capital raising process.

Really thinking through business value from all stakeholders' viewpoints and how you can engineer a deal is something worth spending significant time on.

TIP 4 – IF THERE ISN'T A REALISTIC VIEW ON VALUE FROM INCUMBENT STAKEHOLDERS THEN A STAGED APPROACH MAY BE REQUIRED

If there is a 'pre-COVID-19' view on value by the shareholders/directors and you believe that there is a gap on 'realistic value' then you may be best served by giving your client sufficient space to test their view on value.

When the client reengages then a structured solution to determine value may be required to consummate a deal.

TIP 5 – DOES THE COMPANY NEED TO BE RESTRUCTURED IN ORDER TO BE INVESTABLE? IF SO, START AS SOON AS POSSIBLE.

In the 'post-COVID-19 world' many industries will have reduced customers or customers seeking lower prices. A restructure may be necessary for these businesses as revenue could be materially lower.

Most Australian businesses have time to restructure thanks to the government stimulus and legislative changes. This time should be used wisely as many businesses will need to be financially and operationally restructured to make them investable.

TIP 6 – WHEN DEALING WITH PRIVATE EQUITY AND OTHER FINANCIAL SPONSORS MAKE SURE YOU UNDERSTAND THE MANDATE OF THE SPONSOR AND WHAT DEALS IT TYPICALLY DOES.

All private equity sponsors have different deals they seek to do. These 'sweet spot' deals are a result of different:

1. fund sizes
2. mandates
3. history
4. attitude to risk.

Don't be scared of asking a series of questions to help you understand the private equity sponsor's mandate and limitations. Some good questions you should ask financial sponsors are:

What is the mandate for the fund? Are there any limitations (such as size, geography or sector)? This will help you understand whether the investment into the business fits inside the fund's mandate.

What types of deals does the fund do? A review of the types of deals the fund has done on the fund's website will be very informative in helping you assess whether the fund is likely to invest in your business. For example, if a sponsor's last three deals are growth-orientated small management buy-outs then the sponsor may not be a likely solution to a large distressed property deal.

How long does the fund normally invest for? Usually, private equity invests for three to five years. Hedge funds may invest for shorter periods, depending on mandate. If you require longer term capital, then understand if there are mandate limitations.

What is the typical investment size?

What is the decision-making process for the fund? Is it local or overseas? This is a critical question. Are you talking to a decision maker? Local decisioning is generally faster.

Does the fund have any FIRB issues? This is a new issue, as the government has tightened FIRB rules in response to a drop in asset values caused by COVID-19. FIRB is a difficult issue today for many funds as the government has prohibited investment by foreign businesses and funds without government approval. The process is up to six months and the exceptions are limited.

TIP 7 – DON'T MAKE THE INFORMATION MEMORANDUM (IM) TOO DETAILED

In a changing macro environment where forecast financials are continually changing, the purpose of an IM is to engage with potential buyers and investors rather than give a detailed forecast of the world.

Use the IM to engage with the financial sponsor and get their views on risk, value and structure.

Encourage engagement by making the financial sponsor feel special by giving them an early look.

TIP 8 – A QUICK 'NO' IS WORTHWHILE.

A quick 'no' is worthwhile if you ask questions about why the financial sponsor declined to invest. This will help you understand issues connected to you client or mandate issues inside the fund.

TIP 9 – THINK LATERALLY – LOOK AT PORTFOLIO COMPANIES

Make sure you understand what portfolio companies are owned by private equity funds. When you approach the private equity fund try to find the investment director or manager who has an affinity with the sector. They will act faster as they understand the industry.

TIP 10 – CAPITAL RAISING IS AN ART NOT A SCIENCE

Most capital raising processes are bespoke and involve people. If the process is very competitive, with poor information or the process is hard then the chances of success are diminished.

Engage early and phone them. Deals are done by people. Getting engagement is critical to success. Good luck! Hope to hear from you soon.