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Weathering the Global Financial Crisis:
A Survival Guide for Small to Midsize PE Funds

While many in private equity circles have foreseen a "correction" coming, the general response to the current financial crisis has been alarm at how quickly and radically the markets unraveled. While an innate optimism normally drives people in the private equity sector, this crisis and its aftermath will have a long-term impact on private equity - both on the deal side and fundraising. In this issue, we take a look at what fund managers can do to stay ahead of the curve.

When the economy is in growth mode, it's relatively easy to generate good results - the rising tide lifts (nearly) all boats. But as the economy enters a stormy period and even economics experts can't agree what will happen next, a fund manager's mettle is put to the ultimate test. Times like these will expose any weakness in a fund's position and punish fund managers who don't take a fresh, honest look at what they're doing.

Navigating the rough seas ahead demands focus, detail orientation, flexibility, strong relationships, and the ability to make tough decisions. It's not an option to leave in place a strategic plan that was formed under different economic assumptions without thoroughly reviewing it in light of changed conditions. That said, investors are looking for a steady hand at the wheel, and portfolio companies are looking for strong leadership.

Portfolio Companies Need Hands-On Management

Portfolio companies need their investors to be more active advisors now. Your experience and seasoning can help them take a hard look at their position in the market. Take a fresh pulse on customers and competitors. Discuss various economic scenarios and how trends are likely to play out in their industries. Develop a plan B, and C.

Any fund managers who remember the severe economic downturns of the past few decades - following the '87 market crash or the double-whammy of the tech bubble bursting and 9/11 - probably have war stories of dysfunctional boards and skittish co-investors. These groups didn't start out that way, and it's not an inevitable outcome.

Open up lines of communication to nip sniping, in-fighting and other bad behavior in the bud. Make sure your portfolio companies' boards of directors, management teams, co-investors and your limited partners are all on the same page with you about the company's position, industry trends and priorities. Avoid group-think, which can suppress fresh perspectives and critical judgments. By the same token, beware of board bullies, and move quickly to isolate, buy out or cut them loose.

There's no time to lose. As turnaround specialist Ken Yager, Principal at MorrisAnderson, says, "Management is always stunned when someone comes in to tell them they're not doing the right thing. It's human nature. The worst mistake fund managers can make is not being honest with themselves and with their limited partners. Most are experts at growth management, not in shrinkage or cash management - that takes different skills and experience. But now your role is recognizing and calling out that a problem has happened and that it's time to do something."

Chicago-based MorrisAnderson has helped turn around more than 1,400 underperforming public and privately held companies, most managed by PE funds, over the past 28 years. "Step number one," Yager says, "is to insist on transparency - don't advertise issues, but advise key stakeholders - all stakeholders - of what's really going on. Saying the sun will come out tomorrow won't cut it."

Quite often, he says, the general partner is the last one to recognize the situation has changed. Once that has happened, "then things get easier. Get in there and help the portfolio company conserve cash. Growth is not necessarily the best use of capital in the short term. Some projects or employees need to be let go. It's painful, it hurts, but the alternative could be worse," Yager warns.

Cash (On Hand) Is King

"Hunker down in 2009; if you get growth, that's fine, but don't try to spend your way into a growth pattern in 2009," Yager says. "Behind every Horatio Alger story of a guy who spotted a rare alternative is the untold story that the guy had been hoarding cash and was ready to act when an opportunity came along."

"Cut expenses - you almost always need to cut more than you think," Yager says. "We almost never see them over cut. If you didn't cut enough, you'll burn through your reserves."

In PEF Services' collective experience, early-stage companies especially need to focus on cash management - to ensure they can live to see another day. In tough times, fund managers need to use their HR management skills to keep good management teams intact, while streamlining the organization, a delicate balance. If, on the other hand, an early-stage company has funds in place, industry consolidations may make this an interesting time for growth through unexpected acquisitions or deals.

Later-stage investments, too, need to focus on cash conservation, but also bank credit line management. PEF Services is hearing stories of companies that are at risk of triggering bank limits, especially when companies use those same banks for operating funds. It's time for "operating partners" to earn their keep - focus on EBITDA.

Maintain flexibility

For funds with transactions in progress, we've seen bank loans and deals being put on hold, due to the credit crunch. Among your plan B options, consider expanding your co-investor pool, or seeking mezzanine financing. Even good companies are starved for cash - be willing to pull the trigger if you have the cash - don't let good deals get away while other investors hesitate. However, be sure to recognize when a deal isn't a deal: Companies in a more fragile financial state may find credit lines and accounts at risk - know when to walk away.

Credit Crunch Fallout Affects Fundraising

On the fundraising side, fund managers are encountering numerous issues, according to industry observers, but in the current investment climate, again, communications is the key to overcoming these obstacles.

Champlain Advisors Partner Christopher Aidone characterizes the coming year as "a more challenging environment in general for fundraising." The Greenwich, Conn.-based boutique fund placement, advisory and investor-relations firm works with select alternative investment managers in raising institutional capital.

Aidone advises fund managers to use "a disciplined approach; stick to your knitting, be reasonable and conservative. The best GPs have always maintained open and active dialogue with LPs; it's time to increase that openness. It's always best to be upfront and honest with bad news."

Research group Prequin LP published a report* last month that found private equity fundraising for Q3 2008 has sunk to the lowest level since Q1 2005, while a record number of funds are on the road, estimated at 1,601 funds seeking an aggregate $934 billion. As a result, the report states, "fundraising has become increasingly competitive... it is becoming harder than ever for fund managers to raise capital." Another recent analysis by the company showed the cycle taking an average of 14.2 months to complete, up from 11.1 months in 2006.

Aidone confirms this trend. "GPs should anticipate a much longer fundraising cycle in general," he says. "Myriad issues, from overallocation to alternative assets, slowed distributions, turnover amongst LPs, overhang of unfunded commitments, all have contributed to the protracted fund-closing cycle."

Chief among these issues is overallocation. Many institutional investors have watched helplessly as the dramatic drop in stock market values has thrown their target allocations out of balance. According to Prequin's research, in 2007 just over half of all LPs (53%) were under their target commitments to private equity, while in 2008, that figure has declined to only 36%. A year ago, only 29% of all LPs were at or above their target commitments, now nearly half of them (48%) are.

To stand out in a crowded fundraising market, Aidone recommends, "GPs need to prove they've stuck to their strategy, that they've been disciplined in monitoring their existing portfolio before making new investments. You need to demonstrate true operating value-add, with active, daily involvement in the companies' decision making."

It's important to demonstrate your fund has not simply been relying on leverage and financial engineering to grow investments, he adds. "Private equity is a long-term asset class. Certain strategies might be more favorable at certain times, but in general, investors are looking for tried-and-true measures: investment performance, team continuity and performance, as well as LP-friendly policies regarding deal and transaction fees."

Another Prequin survey confirms this: In a survey of LPs ranking the factors they consider most important when selecting managers to place their funds, the top scores were awarded to "track record/prior returns" and "general PE experience," followed closely by "alignment of interest" and "depth of team." Interestingly, Prequin found, technical aspects of a GP's proficiency and strategy, such as fund terms and conditions, or deal-sourcing network, were rated lower, as relationship factors come to the fore.

Complicating the fundraising picture is another fallout from the credit crunch: LP liquidity issues. We're hearing about isolated cases of capital call defaults, as well as delays or higher restrictions in securing funding from banks to close a deal. Consequently, fund managers may need to be flexible and allow extra time for capital calls, find new co-investors, or allow for lower minimums. Even though down times have been shown to be among the best times for disciplined investing, you still have to get the capital committed from nervous investors. Again, open lines of communications with LPs can reduce surprises.

In times like these, it's important to keep your focus on your game. Investors will reward those fund managers who can prove their skill in managing performance of their current portfolio.

Don't let the burden of managing your financial reporting trip you up: Leave the details in the hands of professionals like PEF Services, while you focus on strategic issues and managing relationships. And remember, you're not in this alone. PEF Services is here for you with advice on what we're seeing across a broad range of clients.

** Source: Prequin LP Survey Special Report, Q3 2008 Private Equity Fundraising Report*