Fachhochschule Wiesbaden
University of Applied Sciences

Company Restructuring by Private Equity Houses – Results of an Empirical Survey

Working Paper

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1 Introduction

In the past ten years, the Private Equity investment environment has been subjected to dynamic changes. In Europe, the number of funds has increased by an order of magnitude. Within this time-frame the amount of capital available to Private Equity companies increased ten times by the year 2000 and thus even more quickly. The majority of participants in Europe were new entrants into the Private Equity market. The increase in market participants has increased transparency in the market and made purely arbitraging profits, i.e. the cheap purchase and expensive sale of an investment without adding any value, more difficult to attain. The rise in available capital increases the propensity to invest and raises the value of equity investments. More market players and more capital put more pressure on attainable yields and step up demands on Private Equity houses' services. The more difficult environment also finds expression in the fact that write-offs of portfolio companies have become the exit route of the Private Equity sector to a regrettable extent. There are in all very few Private Equity houses in Germany which have specialised exclusively in restructuring situations. Nevertheless, numerous companies are reluctantly holding in their portfolios enterprises which are in a critical position and are confronted with financial or economic performance difficulties. This poses – in addition to that relating to value-creating performance – the question of the restructuring capabilities of Private Equity houses.

The present study is based on an empirical and complete survey of the Private Equity sector in Germany carried out by the Faculty of International Marketing at the University of Applied Sciences in Wiesbaden in cooperation with the Corporate Restructuring Department at KPMG Deutschland. Early in 2004 all members of the Bundesverband deutscher Kapitalbeteiligungsgesellschaften e.V. (Federal Association of German Capital Investment Companies - BVK) as well as those members of the European Private Equity & Venture Capital Association (EVCA) active in Germany, but with the exception of aid-oriented companies, and thus a total of 154 enterprises, were approached with a standard questionnaire. 60 companies took part in the study, corresponding to a response of 39%.

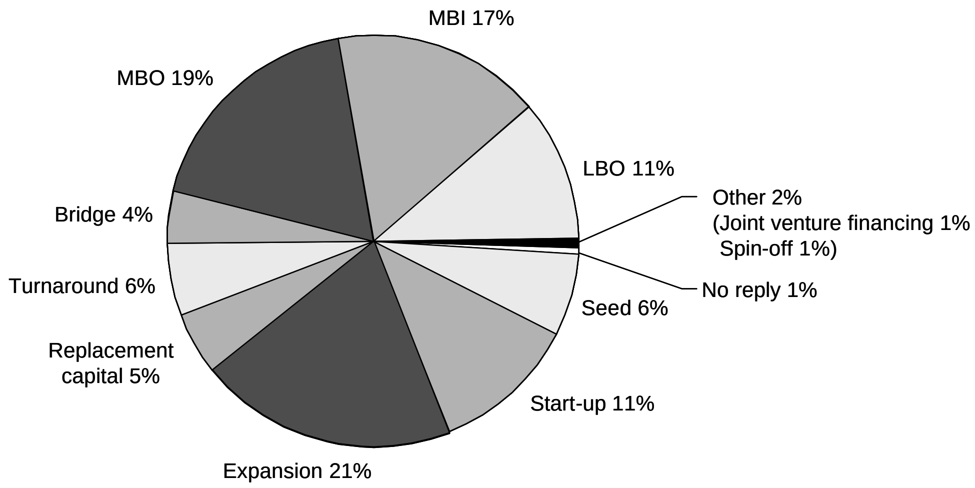
The aim of this study was to make a contribution to understanding the value-enhancing approach of Private Equity houses as a whole. In view of its current major significance, the company restructuring aspect was placed to the fore. From this perspective, the performance of investing companies and that of external service providers was to be compared in a differentiated manner and in general the use of external specialists examined.

The results provide sophisticated statements about the value-creating activities of Private Equity houses. They permit – in relation to the overall image of the sector – conclusions about an as yet incomplete differentiation and communication of own performance, but also about increasing professionalism. In all it becomes clear that – apart from some very positive exceptions – operative abilities are not being sufficiently attended to or presented and that therefore value-creating potential is lying fallow.

2 Results

2.1 Participant profile

The structure of the participants displays an increase in activities in the areas of replacement capital, turnaround and bridging (cf. figure 1). Expansion and start-up are still in retreat. Nearly half the investments are in the exit phases MBO, MBI und LBO, while investment in the seed and start-up phases plays a subordinate role.



Basis: 59 respondents; multiple answers possible

Fig. 1: Investments by financing phase

The distribution of investments by investment sector reflects a typical picture of the participations market. Roughly half the investments (45%) are in high-tech sectors (hardware, software, communications technologies, bio and environment technologies and medicine). Participations in traditional sectors (iron/steel/light metals, mechanical/plant engineering, industrial automation, chemicals/materials) comprise about one third (30%).

25% of respondents manage a fund value of up to € 50mn, a further 20% a fund value of up to € 100mn. In all, 20% of respondents manage a fund volume of more than € 500mn. Large funds engage – in absolute terms – in large participations and also tend to invest in companies with more turnover than smaller funds do.

With regard to relative levels of investment minority participations predominate. Half of the respondents (49%) also take small minority participations of less than 25% in enterprises. 26% of the Private Equity houses asked only engage in majority participations of over 50%. Majority participations from 50% upwards are typically sought by turnaround specialists.

2.2 Recognising the need to restructure a company participation

Private Equity houses resolve to restructure a company participation once the causes or indicators shown in Figure 2 are present. Impending illiquidity and management incompetence are by far the most frequent reasons for restructuring an existing participation. Further grounds for restructuring are market collapse, fierce competition and failure to market technology.

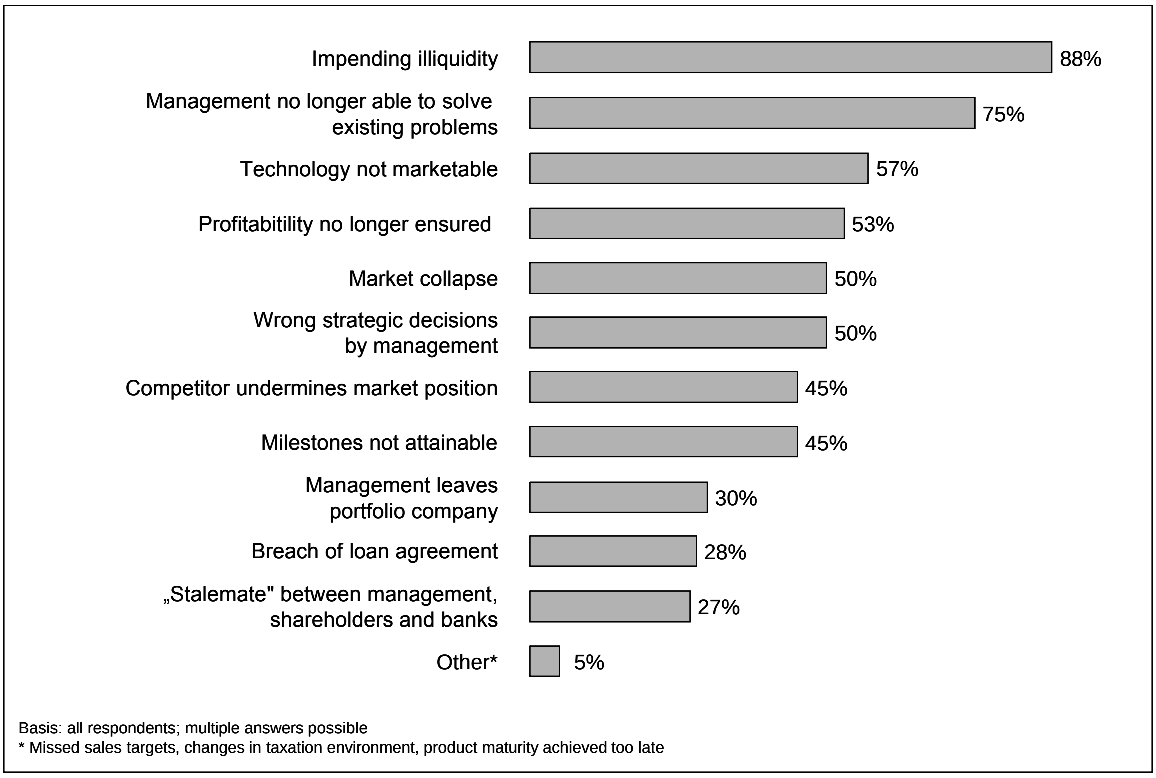


Fig. 2: Indicators for restructuring measures

According to the Private Equity houses asked, most restructurings are completed successfully (cf. Figure 3).

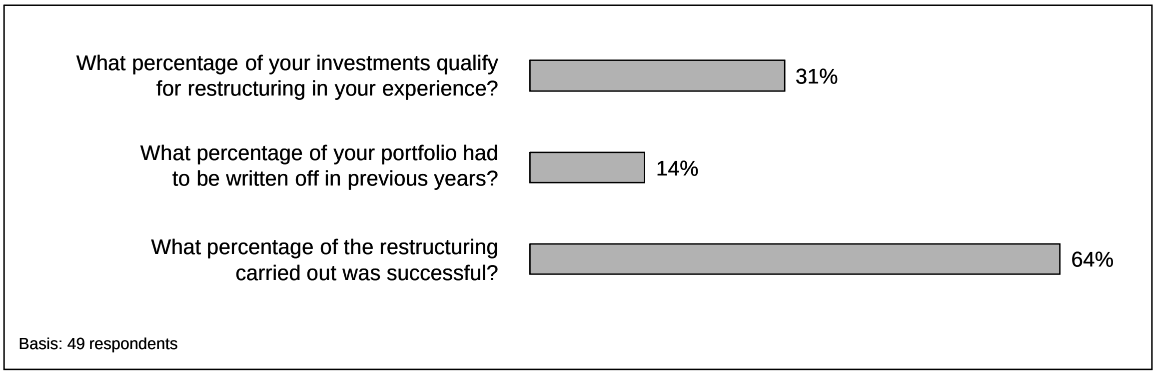


Fig. 3: Specific questions on restructuring

The low rate of write-offs determined here in comparison to the official BVK statistics is explained by the exclusion of aid-oriented companies from this survey and the five-year time observation horizon on which it is based.

Restructuring a participation is dispensed with when a further round of financing has failed, when the restructuring attempt produced no results, the safeguarding of controls was not possible within the shareholder structure or a petition to dissolve the company has been lodged.

2.3 Restructuring competence of investor

Investors place their emphasis on controlling and finance. The operating functions of the enterprises invested in are less well supported by Private Equity houses. (cf. Figure 4).

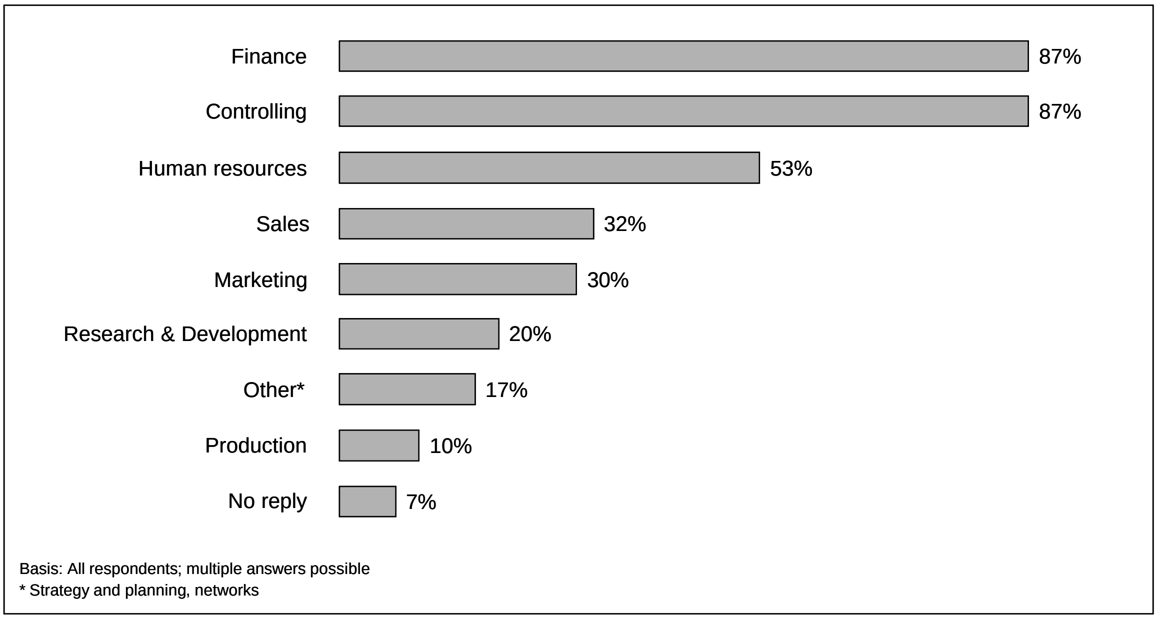


Fig. 4: Restructuring competence by operating function

The emphasis on finance-driven control can also be seen when considering the investors' contribution to restructuring business processes. Balance sheet management (82%) and reporting (77%) are most frequently named as starting-points for restructuring. Operative restructuring measures such as the implementation of cost-saving programmes (60%) or the standardisation of operative processes (40%) are mentioned less frequently. On the whole, Private Equity houses appear to rely on the proper construction of the pre-conditions for coping with a crisis to reduce or avoid the need for direct operative turn-round measures.

With regard to the restructuring of company structures, Private Equity houses perceive their added value primarily in complementing the management team (90%) and in the reorganisation of the shareholder structure (85%).

Within the framework of the investors' self-assessment of their own restructuring competence, the core competencies are perceived to lie in the strategic realignment of portfolio companies and in concentration on their core competencies (cf. Figure 5). In addition, skills in identifying potential strategic buyers and referral within their own network are dominant. Operational competencies, such as in optimising operating processes or in marketing measures are rate distinctly lower. This assessment is completely independent of the financing phase in which the investor is engaged.

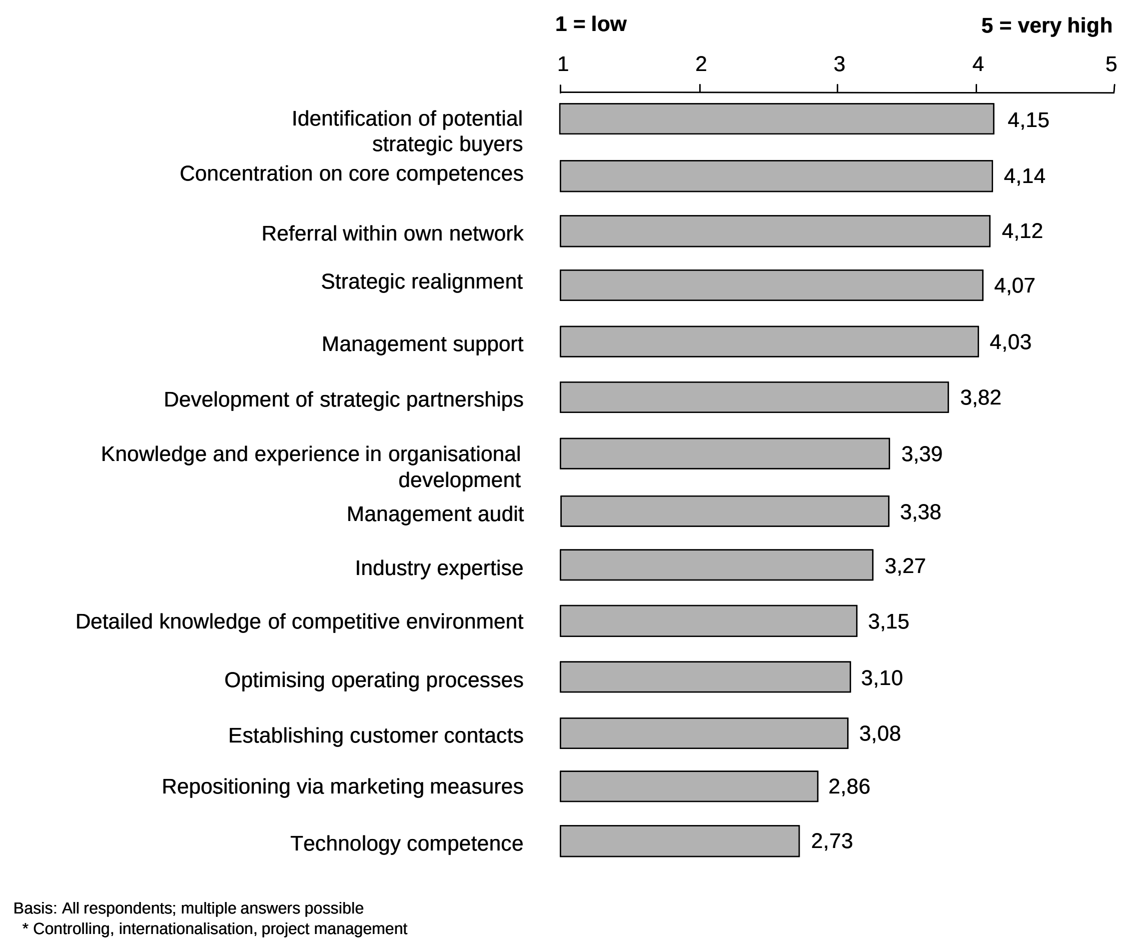


Fig. 5: Self-assessment of restructuring competencies

2.4 Use of external restructuring know-how

The deployment of external service companies for restructuring measures by Private Equity houses is presented in Figure 6. Overall, temporary managers and specialised restructuring consultation head the list of service companies engaged when external support is needed.

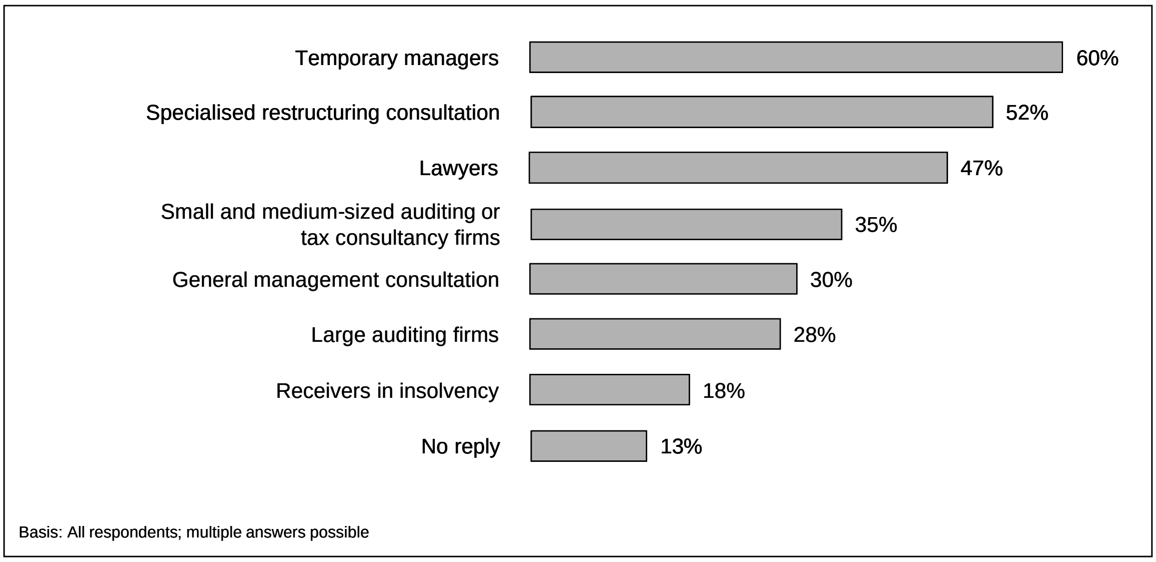


Fig. 6: Restructuring services by business function

Private Equity houses make great demands on service companies when cooperating on restructuring measures. In addition to personal competencies such as professionalism, realisation and achievement abilities, restructuring knowledge and specific restructuring experience count here. Name and size are of lesser importance when selecting an external restructuring consultant.

When asked at what hierarchical level of the portfolio company external restructuring companies are employed, the absolute majority of the Private Equity houses asked replied with the highest level of management (cf. Figure 7). Further emphasis is placed on the strategic level, while the operative level is less heeded.

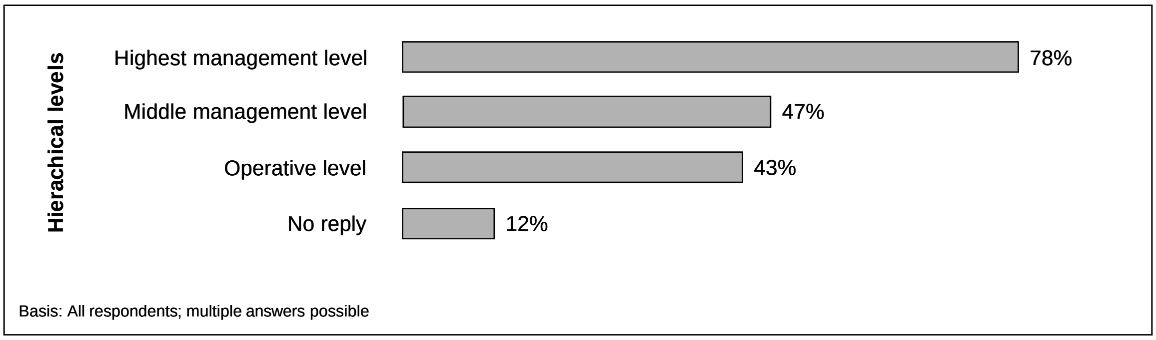


Fig. 7: Use of external restructuring companies by hierarchical level

However, a cross-analysis of this observation with the question concerning the success of the restructuring shows a distinctly higher proportion of success in those restructuring cases which solely address the operative level. However, the number of cases at n = 12 is so small that it is only possible to speak of a tendency. Nevertheless, the study does prove the great significance of operative restructuring measures.

The Private Equity houses surveyed were asked to highlight the anticipated contribution of external service companies to restructuring with respect to the value-increasing measures named in Figure 8.

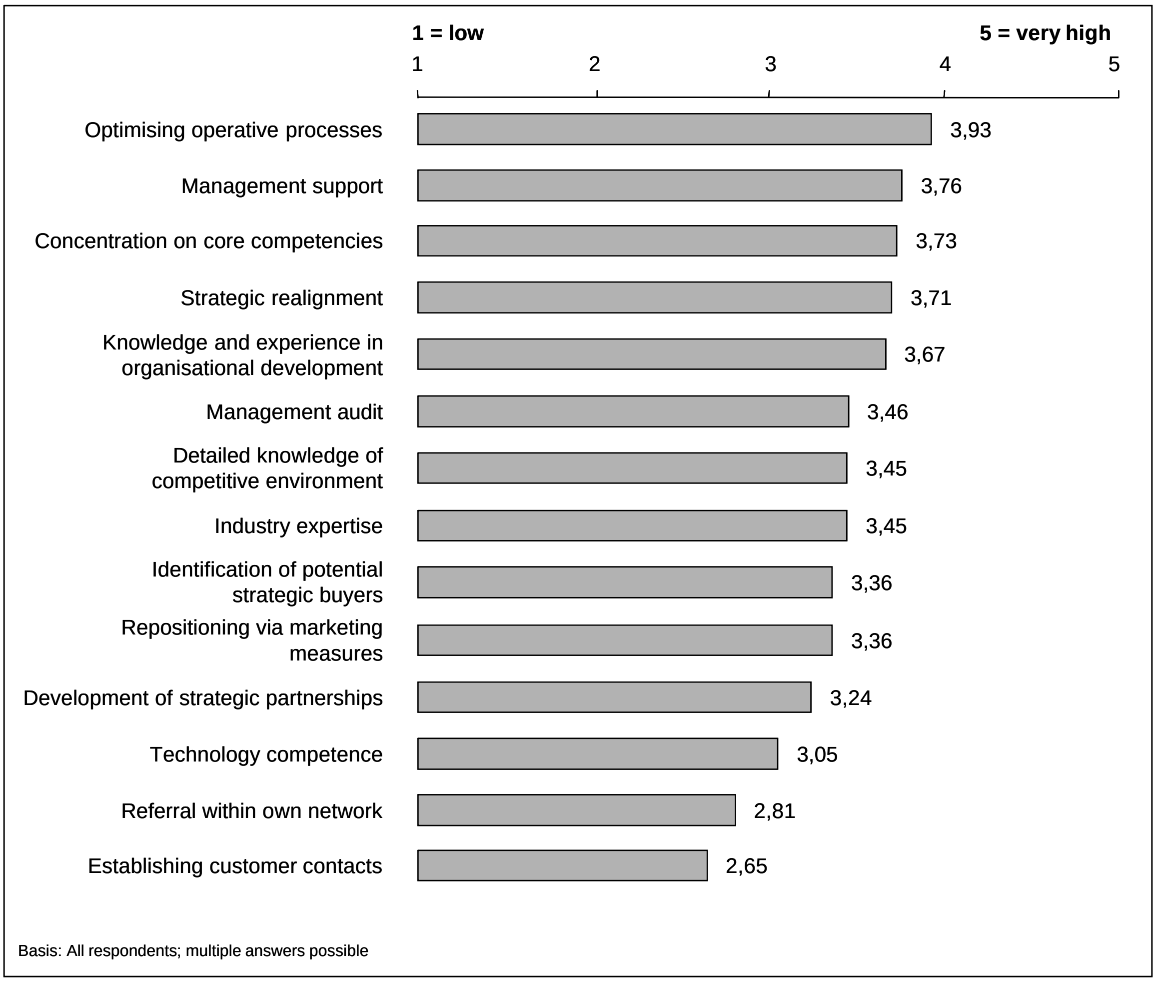
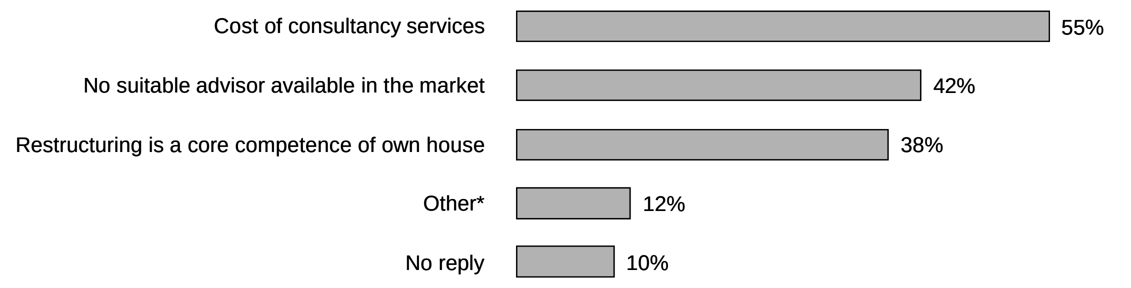


Fig. 8: Assessment of restructuring competence of external service companies

External help is assessed very highly above all in optimising operative processes. Furthermore, in addition to management support, with concentration on core competencies and strategic realignment, tasks for which own competence is also highly regarded play a major role. Establishing customer contacts or referral within own network are not considered to be the responsibility of external service companies.

A comparison of the restructuring competencies of Private Equity houses and external service companies shows that Private Equity houses classify their own competence with relation to strategic tasks even higher than in the case of external service companies. The latter are conceded a small lead in optimising operative processes and in various special areas such as marketing, industry expertise, knowledge of the competitive environment, organisational development and technology competence.

The cost of consultancy services prevent more than half the Private Equity houses from restructuring their portfolio companies, closely followed by the shortage of suitable consultants and the fact that restructuring competence is rather perceived to be in ones own house (cf. Figure 9).



Basis: All respondents; multiple answers possible
* Reducing the liability of fund employees due to de facto management; ROI of consultancy services, familiarity with industrial sector

Fig. 9: Reasons for dispensing with external restructuring services

2.5 Success measurement and assessment of restructuring

In addition to financial restructuring and the margin between purchase and exit multipliers when valuing the portfolio company, the profit which a Private Equity house can achieve with a transaction is in particular determined by the improvement in the operating result. The following section presents the success factors of a restructuring. Criteria for assessing the success of a restructuring are also named (cf. Figure 10).

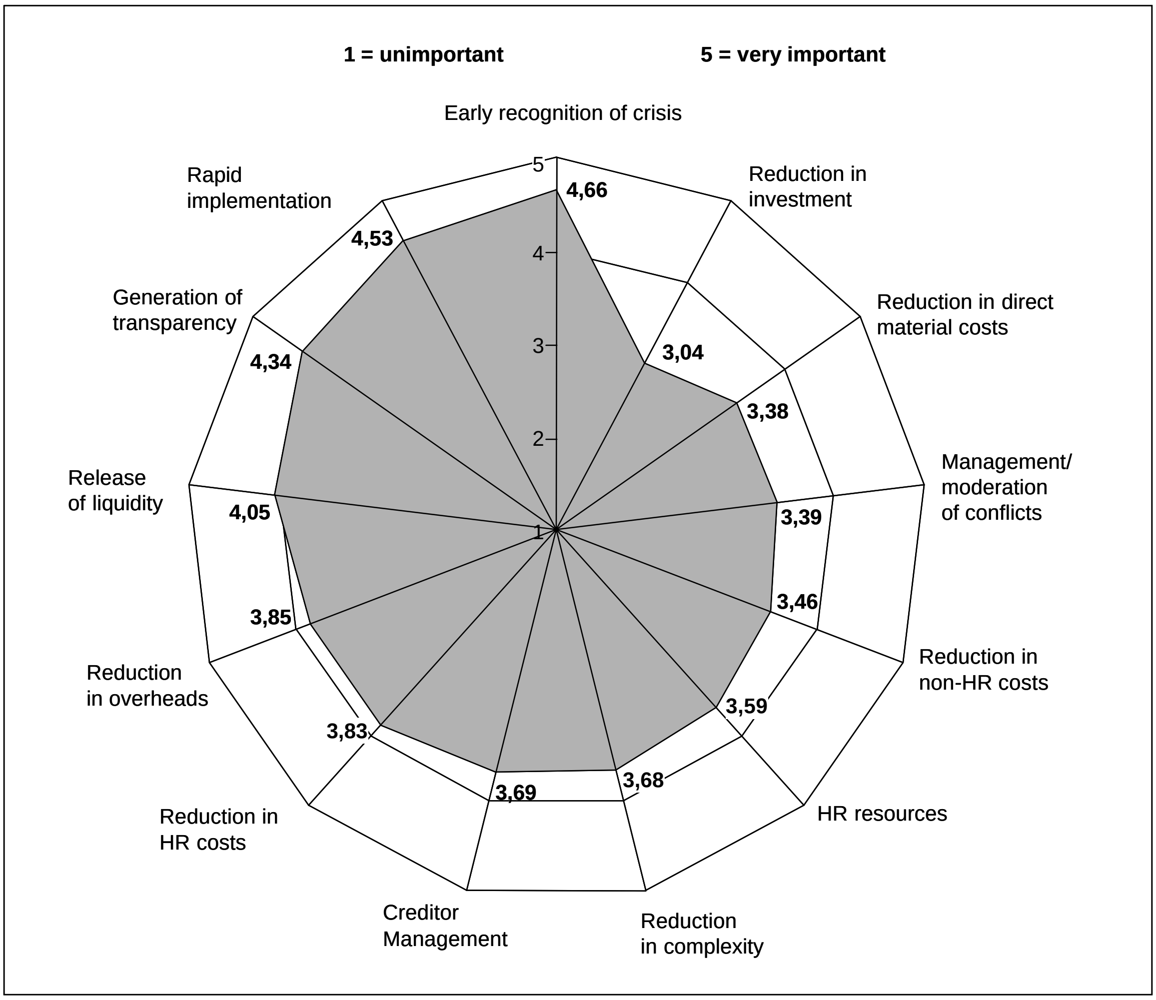


Fig. 10: Restructuring success factors

The decisive success factors in restructuring are operative abilities such as early recognition of a crisis, rapid implementation and the generation of transparency.

3 Summary of Results

Core competencies in the areas of strategy and finance

The study presents an overall picture of Private Equity houses who control their investments by means of financial ratios and see their added value in the strategic realignment of their portfolio companies and their referral within the network of Private Equity houses. They do not see any other operative tasks as being their core competence.

The Private Equity houses surveyed see their restructuring competence primarily in the realignment of finance, controlling and strategy.

Operative support by external service companies

Optimising operating processes and temporary management are preferably bought-in from external service companies. A comparison of the restructuring competencies of Private Equity houses with external service companies shows that business operations are seen as a core competence of external service companies.

Restructuring success lies in operations

Unexpected in the overall view is that precisely operative competencies are recognised as an important factor for the success of a restructuring, although operative competencies are not considered to be a core competence by the Private Equity houses. Restructuring successes can to a large extent by explained as operative support by external service companies. In addition to operative competence, other decisive factors for a successful restructuring are early recognition of the crisis and rapid implementation of the necessary restructuring measures.

Personal competencies decisive

Private Equity houses make great demands on service companies when cooperating on restructuring measures. In addition to personal competencies such as professionalism, realisation and achievement abilities, restructuring know-how and specific restructuring experience count here. Name and size are of lesser importance when selecting an external restructuring consultant. In the case of external restructuring, predominantly specialised restructuring advice and interim managers are called in.

Restructuring is mainly successful

According to the Private Equity houses asked, 31% of participations qualify for restructuring measures and 64% of restructurings were carried out successfully. Willingness to restructure and also the success thereof increase in proportion to the relative stake of the investor. Total losses (divestment by write-off) are mainly recorded in New Technology cases. In contrast, the so-called „old economy“ displays a greater proportion of successful restructurings. Early phase investors are more inclined to write-offs than late phase investors.

Cost and a shortage of qualified consultants are the bottle-necks

Dispensing with external services is explained in the first instance by the cost of the consultants. 42% of the enterprises surveyed do without external restructuring consultants owing to the shortage of suitable market offers. A further 38% see restructuring as being one of their own competencies.

Authors

Prof. Dr. Stefan Jugel is professor of international marketing at the University of Applied Sciences in Wiesbaden. Parallel to his academic activities he sits in the board of several young, fast growing companies. Stefan Jugel is author of various empirical studies and publications about the German venture capital and private equity market. Prior to this he worked in several positions with Robert Bosch GmbH, at the end as director sales responsible for a sales volume of 400 million EUR in 14 countries in Western Europe. He holds a master degree of business administration and economics of the Universities Mannheim and Paris-Dauphine and got his PhD from the University of Mannheim.

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