Private equity and the liquidity crunch: what's happening?

The liquidity crunch presents the private equity industry with both its biggest challenges and its greatest opportunities, particularly in the black economic empowerment arena.

Stephen Brown and Mike Donaldson, executive directors at captive private equity fund RMB Corvest, say almost every aspect of the private equity arena is impacted by the shortage of capital. Many private equity funds have depleted their war chests and attempts to raise new funds from wary investors are proving problematic.

Donaldson says private equity has had a good run over the past five years and it acquired a lot of large assets.

"Funds have been caught at the point in the cycle where they have spent a lot of money and need to raise more cash. Adding to their woes, asset prices are a bit lower and it is the time for private equity funds to invest, if they have the money," Donaldson says.

Captive private equity funds such as RMB Corvest face less of a challenge as parent companies with healthy balance sheets can provide additional capital. However, captives find they have to compete with other areas of business for funds.

"Investment committees are becoming tougher and capital is becoming a scarce resource," Donaldson says.

Further, when private equity firms want to do a deal, they seek to incorporate senior or mezzanine debt into the transaction and it is often the level of gearing introduced that makes a deal viable.
However, raising funds from senior debt providers is difficult and expensive.

"It is difficult to structure a deal and the private equity player has to put in more equity and, thus, it takes more capital to fund a deal. While covenants are similar to those prevalent in South Africa in the past, the earnings before interest, taxes, depreciation and amortisation (EBITDA) ratio to the level of debt has changed. A few years ago we were borrowing up to three to four times EBITDA and now the maximum is closer to two times EBITDA," Brown says.

Adding to the complexity of the private equity environment is the fact that P:E (price to earnings) ratios have not come down as quickly as the industry had hoped.

"This leaves a gap between the price you are paying for the business and the debt that you can raise," Brown says.

However, the lack of liquidity has a silver lining for the private equity industry, opening up some consequential opportunities. "Given poorer trading conditions and lower P:E ratios, some BEE deals could be in trouble," Brown says.

In addition, BEE companies need to borrow additional funds to finance new deals but banks are reluctant to lend into the special purpose vehicles (SPVs) usually formed for new BEE transactions.

"Companies are happy to lend directly to a good business entity and we are still seeing a number of such deals. However, in intermediary deals, lenders are more cautious as they have no direct line of sight into the target," Brown says.

He says a number of deals may, therefore, end up being underwater and there is likely to be a wave of reinvestment and restructuring taking place. This is an opportunity for private equity players that have access to cash as they are able to step into this niche and fund the transactions.

"The private equity player takes an equity approach to its lending, which gives it an advantage over pure bank lending. Private equity participants understand and take a view on the underlying asset and the BEE party involved and they are able to take a longer term view of the transaction," Donaldson says.

Assuming that the underlying asset is good, the private equity company will put a lending structure - usually through preference shares - in place. This approach highlights a major difference between private equity and bank lending, namely that the debt does not have to be serviced.

"We take a longer view and we will have a target as to how much we expect to make on the deal," Donaldson says.

In cases where the BEE group's deal is distressed, the private equity player will seek a new BEE party to buy out the existing BEE investor at a lower price, one that reflects current fair value.

"However, when the new BEE partner is introduced, there may still be space for the old one within the structure of the new deal," Brown says.

-ends-

Distributed on behalf of RMB Corvest by: Percheron Public Relations & Marketing

Gillian Pinks

Tel: +27 11 447 8137

Cell: +27 82 892 8378

email: gillian@percheron.co.za

For further information please contact: Mike Donaldson / Stephen Brown

RMB Corvest

Tel: +27 11 380 8300

Cell: +27 83 326 5449 / +27 82 931 9723

email: mike@rmbcorvest.co.za / stephen@rmbcorvest.co.za

Notes to editors

RMB Corvest is a private equity company and a member of the FirstRand Limited Group. We offer clients a key advantage through our status as an on balance sheet private equity company, using our own funds for investment rather than third party funds. As a result, we do not have exit timing pressures and are able to invest for the longer term.

Founded in 1989 by Neil Page, Dick Merks and Dave Rissik, our company invests in established, well-managed businesses across South Africa with a proven track record of solid performance. Neil and Dick remain actively involved in the company, adding a valuable contribution to strategy and direction.

With well over 140 deals completed to date, an established track record, staff highly experienced in private equity and access to the resources of the RMB group, we provide a comprehensive private equity offering. In addition, as an on balance sheet company and through our commitment to dedicated, long-term relationships and service excellence, we are well placed to add more value for our partners.