Diary Jon Moulton

Hard times are coming. So what should private equity firms be doing?

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

I feel rather smug. While the youngsters (under 40, say) have never really seen a weak economy, I've lived through miners' strikes and winters of discontent, and two years after I started in private equity, unemployment was 12%. That experience may prove useful again!

In 1989 and 1990, insolvency was the most frequent form of exit for UK leveraged buyouts.

Most players in today's PE market have seen nothing different from the base rates of 1% or less that applied from February 2009 to May this year. In contrast, the base rate was 14% when I started doing management buyouts in the UK in 1981 – portfolio companies paid as much as 18% for senior bank debt.

The possibility that things will revert to these horrible numbers certainly exists. But, like everyone else, I do not know what that likelihood is.

My gut tells me that interest rates will rise quite a lot from where they are today and (more confidently) that inflation will stay high for longer than the Bank of England projects. This is because of a mixture of the massive printing of money and the real difficulty in the modern world in seeing the standard of living drop because of below inflation rises in wages – industrial disputes will exert pressure.

We are already seeing corporate failures rising. In August, the UK had nearly 2,000 company insolvencies – 43% up on the previous year and 42% on the pre-pandemic August 2019. Everything says this trend will continue.

So, what should PE firms be doing in response?

Well, thinking about entering the worlds of distressed debt and turnaround investing seems very logical. Assembling teams with the right acute financial and operating skills, together with a technical knowledge of how to operate in the near and actual insolvency worlds, would seem like a smart move.

Checking the banking facilities and especially the covenants of portfolio companies is an obvious action.

'Remember, the future no longer belongs to the optimists but to the survivors'

It is critical to move the balance of focus in portfolios from chasing growth to worrying about survival.

The accounting skills in much of the venture world I see are not good. Last month, I received a 40-page corporate investment presentation that instead of balance sheets or a cash flow forecast had three slides on appropriate ARR valuation statistics. Dreamers.

It is still common to see venture companies raising lots more money (often to "invest more in marketing") than their P&L projections imply they need. If you haven't got a good FD – get one!

A lot more effort now needs to be put into forecasting. Consumer demand will likely fall soon. Sterling weakness could really hurt companies that import goods. Customers will pay slower and some will go bust. Interest rates could rise. Trying to ensure survival will mean thinking hard about staffing levels. In a weak demand environment, marketing spend may no longer be economic. Tight control over working capital will no longer be an option but a necessity. Head for break-even.

Remember, the future no longer belongs to the optimists but to the survivors.

Investor LPs really cannot do much in a downturn. The likelihood is that more cash will be needed for portfolio companies as banks pull their horns in and exit and that distributions will decline. Net investment will rise, doubtless assisted in some cases, by the banks dropping subscription lines and other over-clever leveraging.

However, it will not be entirely wasted time to point out repeatedly to GPs that cash management is now really important and pumping money into hard-to-finance, weak businesses is not necessarily acting in the interests of the investors. There will be a tendency for GPs to be slow in dropping valuations as finances and markets tighten. Asking about portfolio liquidity is likely to be more useful than in better times.

Planning for the worst has not been a winning strategy in the past 15 or so years. It may well be so for the next few years.

The experience of living through miners' strikes, winters of discontent and unemployment of 12% may prove useful again

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