

There has been a lack of transparency in the private equity sector and weaker market players have failed in the past two years. Could better risk management in the private equity sector mean a safer ride for everyone in turbulent financial markets?

# Good risk management also essential in private equity sector



The importance of managing risks properly in the business community and non-profit sector has never been as manifest as over the past two years. After the international financial/economic crisis erupted, a huge number of companies and organizations worldwide were no longer able to survive under their own steam. Huge debts, rocketing interest charges, excessive general costs accompanied by dwindling sales and results and – in the banking sector – too many risks with overly complicated financial products led to astronomical write-offs. Could the entire crisis have been averted? Perhaps not. Could the

It is, therefore, a pity, according to Prof. Peter Roosenboom of the Rotterdam School of Management (RSM Erasmus University), that so little is known scientifically about the secret recipes of private equity. He wants to map out the PE sector to gain a greater insight into how private equity investors operate and to see the value they add to their portfolio companies. Roosenboom believes that greater transparency is in the interests of the community as a whole and of the private equity players. He says: “It will help to create a better picture, which is badly needed.” Private equity is a term used to denote investments in unlisted

damage have been limited? With hindsight, yes; with solid risk management, absolutely!

This also applies to the private equity (PE) world, where young inexperienced private equity players have failed or are in danger of going under because of insufficient capital to steer their companies operationally through the crisis. A significant number of failures are anticipated. It appears to be business as usual only for muscled players such as Carlyle, Goldman Sachs PIA, TPG, KKR, CVC, Apollo and – nearer to home – Alpinvest. They are all major international names that have come through a variety of storms in the past and do not intend to dig deep (or deeper) into their pockets this time.

#### **Greater transparency badly needed**

Over the past decades venture capitalists have secured a place in the economic order. Their social impact is evident (see sidebar 2).

companies. PE people dislike the media placing private equity in the same category as hedge funds that are out purely for short-term profit. Private equity players work systematically and their average investment horizon is five to seven years. As soon as they get into a company they draw up a strategic plan together with the managing board, regardless of whether they or somebody else provides the board. From the outset the guiding principle is to manage by efficiency. Wherever necessary they pump additional capital into the company (as repeatedly seen in the recent past) to strengthen stockholders’ equity and to reduce indebtedness. The market and society do not (yet) have a clear overall picture of how this takes place. This obscurity is the source of numerous misconceptions. So Roosenboom may very well be right to call for greater transparency.

Roosenboom has been the occupant of the university’s Finance and Private Equity chair since September 2008. He stresses that he sees no link between the present crisis and the role of private equity players, although he adds: “But I do expect to see inexperienced private equity players having problems because of the crisis, mainly due to using too much borrowed capital to finance companies and thus excessive leverage. You can see it unfolding now.”

#### **Survival of the capitalized**

Who will survive? Roosenboom believes that a distinction must be made between funds that have money sitting on the shelf and those with less capital. He says: “The strong ones with money might even prove to be lifesavers and for them the crisis has also

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opened up new opportunities. For proof of this, you simply need to look at recent investments by private equity players in the automotive sector, with car dealers now supported thanks to PE.” Roosenboom warns that funds with less money on the shelf may find themselves in deep trouble: “They’ve done too little in the way of risk management. These private equity players were established in golden times. They found it easy to raise money and were able to invest a lot. But the value of those investments is evaporating dramatically due to the financial crisis. This is happening while they still have to stump up interest charges and other costs and in a situation where there are few if any exit possibilities.”

He goes on to explain that, when risks increase at companies the banks step away and the enterprises enter stormy weather. “I see an important role here for private equity players who have a lot of capital. To some extent they can assume the role of the banks. Banks provide capital with the goal of getting back the loan plus interest. Private equity players finance companies at their own risk through stockholders’ equity and in return want control over the enterprise. That is why private equity players quickly step in to take action and can intervene in the managing board. The supervisory boards of listed companies fulfill the same role, but we know from experience that they often intervene too late.”

#### **Risk management at mid-sized companies**

This leads Roosenboom directly to the conclusion that something

extraordinary is going on. He points out that listed companies have a certain responsibility towards their stockholders, while the supervisory board was created to exercise supervision over the executive board. Mid-sized unlisted companies usually have a small group of stockholders, including a managing director with a major stockholding. The stockholders automatically keep a sharper watch on the executive board.

“I can imagine more risk management requirements being imposed on large unlisted companies in the future,” says Roosenboom. “As companies become bigger and more complex it gets more difficult to oversee the risks. One possibility might be the mandatory reporting of how risks are being managed (similar to the risk management provisions embodied in the Dutch corporate governance code)”.

Asked whether the Netherlands has too many rules – something that can work counter-productively when setting up good risk management – Roosenboom points out that “rules exist for a good reason. But they mustn’t create obstacles in the way that the Sarbanes-Oxley Act has done (legislation introduced in the USA following major accounting scandals at Enron and WorldCom). The existence of too many rules has resulted in numerous companies giving up their listings”.

Roosenboom notes that some players act ahead of upcoming legislation. As a positive example he mentions AlInvest (a joint venture of the ABP and PGGM pension funds). AlInvest was one of the first private equity players to publish an annual report. >>



## The top five risks for companies according to Prof. Peter Roosenboom:

1. The credit crisis has curtailed financing possibilities and, consequently, investments. Especially for SMEs and capital-intensive companies the credit crisis can trigger problems (limited availability of bank loans with attractive rates/conditions).
2. Further deterioration of economic conditions.
3. Increasing environmental legislation. Companies in certain sectors (such as the chemicals, utilities and automotive industries) will be confronted by tougher environmental requirements and the costs involved in meeting them.
4. The merger and takeover market is largely at a standstill. But some enterprises are seizing the opportunity to acquire/rescue companies in trouble at a low price. However, this needs to be accompanied by intensified due diligence to avoid buying a dud.
5. Deteriorating reputation of the sector, possibly leading to a tightening up of legislation. The banking industry is one example.

## Private equity in the Netherlands...

**1,050** enterprises in the Netherlands  
**320,000** employees in the Netherlands  
**€84** billion combined turnover, equal to 14.5% of GNP  
**€23.3** billion in managed assets  
**€1.8** billion in investments, of which more than **70%** in the Netherlands.

Source: Dutch Private Equity & Venture Capital Association (NVP)



◀ continuation from previous page

Roosenboom welcomes transparency initiatives of this kind “because sometimes you have to open your door to get your message across”.

#### **Looking to the Future**

Prof. Roosenboom predicts a substantial shake-up in the capital market in the coming years. Taking on debt as a means of financing is very risky, as we have seen. Over the past few years the debts have been refinanced at higher interest rates. The consequences will only become evident in the coming years. Roosenboom adds: “A lot depends on how quickly the economy recovers, or in other words the resolution of the financial crisis, but one certainty is that the portfolio companies must continue to operate robustly if they are to continue bearing the interest charges. Otherwise they will have to go back to the capital market for more money or seek recourse to the assets of private equity players.”

Inexperienced private equity players are unlikely to survive. Nor does Roosenboom expect to see soon any further billion-dollar deals in the buyout market. “They were pegged to cheap loans and few if any of those are now available,” he says.

Various listed and unlisted companies have been forced to refinance this year. This entailed agreeing higher premiums with the banks. Roosenboom acknowledges that this is the biggest danger. He says: “We are now seeing a cautious recovery of the financial markets. Interest rates are low and money is flowing back into the stock market. But an improvement of the economic conditions is even more important. There are budding signs of recovery, but it is still too fragile. I expect to see a slow recovery that may take years.”

With banks no longer amenable, the private equity players have taken on a big role. It is a welcome turn. To create broader support in the community at large, there is a need for research into how private equity players operate. ◀

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