

# Navigating your portfolio through turbulent waters

---

Timely topics in private equity Issue 1

ACG



### About the author



**Harris Smith**  
Managing Partner, Private Equity  
Grant Thornton LLP

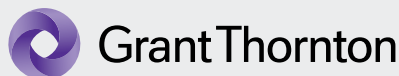
Harris possesses a deep understanding of the accounting and business issues of several industries, including manufacturing, distribution, construction and service, and has served clients ranging from large owner-managed organizations to publicly traded multinational corporations.

Harris is a member of the firm's national leadership team overseeing services to private equity firms. Harris is responsible for the development of strategic relationships for the firm, working closely with private equity firms and their portfolio companies. These relationships serve to further elevate the firm's reputation and to create relationships with key influencers to deal with challenges in the marketplace and to enhance our brand.

Harris has more than 30 years of public accounting experience. He started his career in the Baltimore office of Grant Thornton in 1976. Harris was later promoted to partner, and in 1989 he relocated to the Southern California office to head up its Audit practice. In 1998, he was promoted to office managing partner of the Greater Bay Area offices, and in 2003 he became the West Region managing partner. In 2008, Harris became the Audit practice leader for Southern California and managing partner of private equity for the firm.

Harris is a director, executive committee member and chairman of the Association of Corporate Growth (ACG). He served as president (2003) and director of the San Francisco chapter of ACG beginning in 2000. He is a member of the California Society of Certified Public Accountants and the American Institute of Certified Public Accountants. Harris graduated from the University of Baltimore with a Bachelor of Science degree in accounting.

### About the sponsors



The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Our vision is to be a firm comprised of empowered people providing bold leadership and distinctive client service worldwide. As such, Grant Thornton understands the unique needs and strategies of private equity firms and their professionals. Throughout the life cycle of a fund, we deliver timely value through our audit, tax and other advisory services. Visit Grant Thornton LLP at [www.GrantThornton.com](http://www.GrantThornton.com).



The Association for Corporate Growth (ACG) is the global community for M&A and corporate growth professionals, helping connect capital with opportunity. ACG provides its members with the research, tools and networking opportunities to grow their businesses and themselves professionally. Founded in 1954, ACG has grown to more than 12,000 members from corporations, private equity, finance, and professional service firms representing Fortune 1000, FTSE 100, and mid-market companies in 53 chapters in North America and Europe. For more information, please visit [www.acg.org](http://www.acg.org).

# Executive summary

Private equity firms and their portfolio companies are experiencing some of the toughest conditions since the industry's inception. How is it possible to navigate in these treacherous times? This white paper explores the current state of private equity firms' portfolio companies, examines some of the most prevalent practices for helping them in this difficult economy, and offers best-practices prescriptions for success.

As a result of the credit crunch and the global recession, both of which have caused a reduction in private equity dealmaking, private equity firms are spending more time dealing with the trials and tribulations of their portfolio companies, trying to shield their portfolios from potential losses. Grant Thornton decided to seek a broader perspective on how certain practices are being applied to help private equity firms weather the storm and keep portfolio companies well positioned for the future.

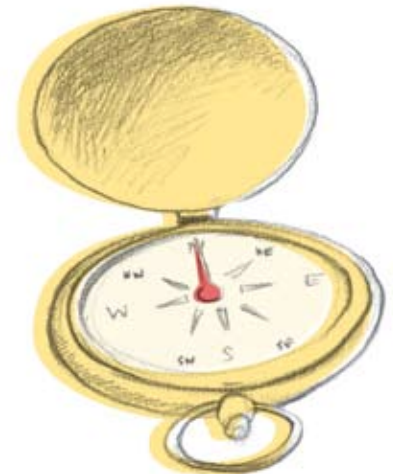
To explore these practices, Grant Thornton searched data points, including Association for Corporate Growth (ACG) and Thomson Reuters surveys, and conducted interviews with key industry professionals about the state of the market and best practices when it comes to managing a portfolio. Through established sources and original reporting, Grant Thornton compiled this white paper, which will give readers a better understanding of the current state of middle-market portfolio companies and what private equity firms are doing to contain spending and minimize losses.

The key areas that we have explored are the state of private equity, the impact of pooled purchasing, the proliferation of add-on acquisitions, the best use of human capital and renegotiating loan agreements.

How is it possible to navigate in these treacherous times?

## Contents

- 1 Executive summary
- 2 The current environment
- 5 Steps for keeping portfolio companies above water
- 12 Conclusion

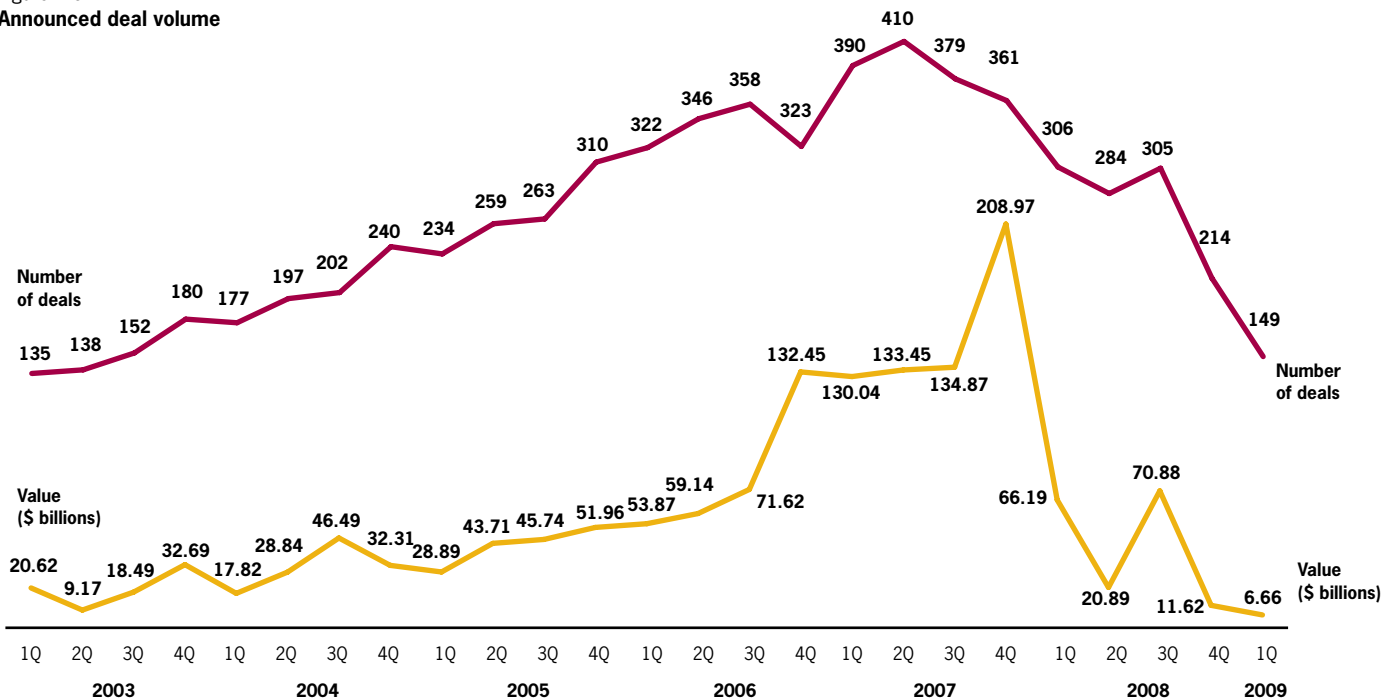


# The current environment

The private equity industry began 2009 in lackluster fashion. Dealmaking has been put on hold, at least for the time being, with the first-quarter deal totals showing the lowest deal volumes in years. (Figure 1.0) The year 2007 produced the third and last year of record deal volume (\$607.33 billion worth of deals were completed in 2007). According to Thomson Reuters, U.S. buyout firms completed only \$169.58 billion worth of deals during all of 2008 and a paltry \$6 billion during the first quarter of 2009.

All asset classes are feeling the pain from the tough macroeconomic conditions. Private equity is no different. However, private equity firms not only have to worry about their future, but the future of their portfolio companies. After years of investing long-term in underperforming companies, completing operational improvement and implementing a growth strategy — all while taking advantage of market inefficiencies — somewhere along the line things changed. Deals started getting done at a frenzied pace at extremely high multiples and being financed with exceedingly dangerous levels of debt. Financial engineering took over and operational improvement took a back seat. While this was happening, private equity was achieving above-average returns for its investors.

Figure 1.0  
Announced deal volume



Source: Thomson Reuters

This unprecedented performance led private equity deal volume to grow almost eightfold from 2000 to 2007. The total capital invested in private equity buyout deals went from being 3 percent of all M&A activity in 2000 to almost 25% in 2007.

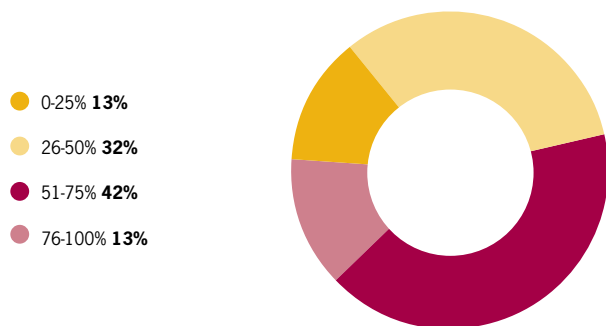
The factors mentioned above, coupled with unprecedented macroeconomic conditions, have painted a scary picture for portfolio companies, many of which are carrying too much debt and barely any liquidity. Now that dealmaking has been shelved for the time being, private equity firms are spending more time working with portfolio management teams to create value at the portfolio level. Private equity professionals are looking more closely at operational improvement as a means of generating returns. In fact, 77 percent of respondents to a recent survey by Gotham Consulting Partners cite operating value improvement as the most important value creator of the next five years, while 64 percent cite financial engineering as the least. In addition, according to a recent ACG-Thomson Reuters DealMakers survey, most private equity firms are spending 51 percent to 75 percent of their time with their portfolio companies, and a whopping 68 percent say they are spending more time with them than they did last year. (Figures 1.1, 1.2, 1.3)

Figure 1.1  
**What is the best strategy for success in the current environment?**

Response	Percent
Buy portfolio company debt	15
Consider more minority/growth capital investments	19
Cut costs at our firm	21
Diversify geographically	6
Diversify by industry	11
Proactive communications with our LPs	18
Focus on our portfolio companies	42
Focus more on add-on acquisitions than platform acquisitions	42
Sit it out and wait for a better investment climate	11
Stick to our original strategy	27

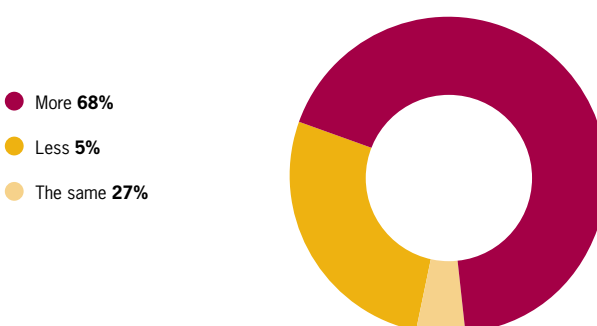
Respondents could choose more than one option.  
 Source: ACG-Thomson Reuters DealMakers Survey

Figure 1.2  
**How much time are you spending on your portfolio companies?**



Source: ACG-Thomson Reuters DealMakers Survey

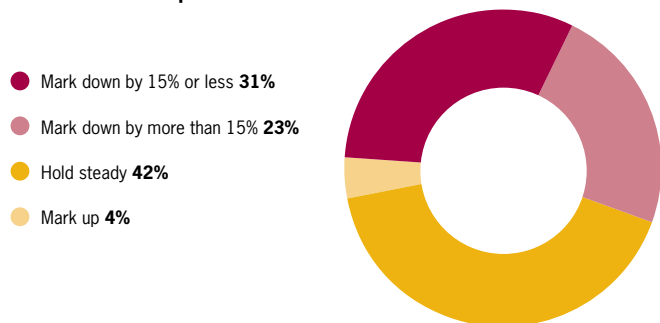
Figure 1.3  
**How does that compare with 2008?**



Source: ACG-Thomson Reuters DealMakers Survey

Figure 1.4

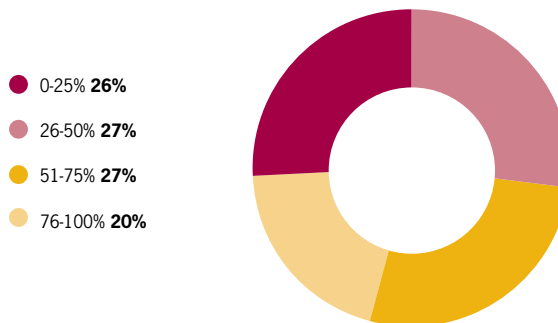
**By what percentage have you written down your portfolio company values in the last quarter?**



Source: ACG-Thomson Reuters DealMakers Survey

Figure 1.5

**What percentage of your portfolio companies are below the prior year in EBITDA?**



Source: ACG-Thomson Reuters DealMakers Survey

After all, the portfolio *is* where limited partners' returns are generated. The management fees that many private equity firms had come to rely on are not a guarantee anymore, as more limited partners have become skeptical of investing in private equity. Financial engineering is gone and will not be back for a long while. And private equity firms must make certain they are protecting their portfolio companies. (Figures 1.4, 1.5)

Creating more value and minimizing costs at the portfolio level are now primary areas of focus for private equity firms. Private equity firms are looking more closely at pooled purchasing programs, loan terms of portfolio companies and retaining top talent on a smaller budget. In addition, portfolio companies' owners are looking more closely at add-on acquisitions for faster growth potential.

**Financial engineering, which was rampant over the last ten years, is gone and will not be back for a long while.**

# Steps for keeping portfolio companies above water

## **Pooled purchasing — Power in numbers**

To say that pooled purchasing is a new concept would be a fallacy. Pooled purchasing garnered the attention of private equity firms in the early 2000s, when the nation was facing a previous economic hardship. Then, pooled purchasing was considered a step forward in the evolution of private equity. And although pooled purchasing was a topic of conversation, adoption of the practice was not widespread. Fast-forward to today, and once again there is conversation, but this time around, more businesses are interested in taking action.

“Private equity firms are working with portfolio companies to find ways to reduce costs across their entire spend, and they are exploring ways to reduce the costs of everything from office supplies to raw materials,” says Stephen Legg, an Audit partner with Grant Thornton. “Private equity firms are utilizing their buying power to reduce costs on a procurement basis. Compensation is the easiest place to start.”

Indeed, with a growing demand for better health care options and the rising costs of providing health care benefits to employees, this is a prime area where private equity firms can and should consider pooling with the purchasing power of a larger group. According to Towers Perrin’s annual Health Care Cost Survey, the average corporate health benefit expenditure in 2009 will be \$9,660 per employee — an increase of 6 percent over 2008 figures. The 6 percent growth rate will make 2009 the fifth consecutive year of single-digit percentage increases. In addition, the Towers Perrin survey shows that total health care costs have increased by 33 percent since 2004.

Furthermore, according to *Health Affairs* magazine, more than one-quarter of all businesses participate in a pooled purchasing health program, with smaller businesses most likely to take part.

“There is an uptick in firms signing up for pooled purchasing of health care benefits,” says Michael Groeger, vice president of the private equity practice for UnitedHealthcare, which enrolls private equity firms’ portfolio companies in health insurance plans. “Private equity firms were hands-off, but in the last year and a half, their level of interest in their portfolio companies has changed dramatically. Everything is on the table, and the portfolio companies are asking for help. Consolidating health care is hard; there are a lot of moving parts to it, but there are savings associated with doing so.”

According to Groeger, private equity firms save an average of 12 percent annually on health care costs when using a pooled purchase health care plan. Pooled purchasing programs make sense for just about every private equity firm with a portfolio of 1,500 employees or more, collectively. In addition to giving larger groups the power to negotiate more competitive prices, pooled health care purchasing is also expected to give the larger group access to better plans and more attentive customer service.

The Riverside Company implemented a pooled purchasing program in 2003, starting with health insurance. At Riverside, the CEOs and CFOs of their portfolio companies meet annually to discuss best practices, issues and concerns. “Better health care options were something that our portfolio companies told us they wanted us to explore, so we did,” says Pam Hendrickson, COO of Riverside. “The program works well.”

Indeed. It worked so well that Riverside has set up pooled purchasing programs in many areas including small-parcel shipping, health insurance and telecommunications. Pooled purchasing programs save Riverside 14 percent on average across its 52 portfolio companies in the United States.

However, infrastructure at the private equity firm is key to the success of such programs. Riverside has a dedicated team that is constantly working with portfolio companies and negotiating rates with vendors. And it's not always easy to get portfolio companies to climb on board. "There's a lot of time invested and communication required," says Jon Kinney, director of strategic analysis and sourcing at Riverside. "Even when you show a portfolio company they will save 30 percent on shipping costs, they can still be hesitant to change services."

Communication is a must. One private equity firm sends its pooled purchasing administrators to meet the management of a potential portfolio company before the deal even closes. Another private equity firm sends out a quarterly newsletter to keep portfolio companies abreast of new pooled programs that have been negotiated, keeping portfolio companies informed, which ultimately leads to happier managers with more knowledge when it's time to make decisions. Riverside sets up steering committees composed of CEOs and/or CFOs to help decide about pooled purchasing programs already in place, as well as for future programs.

"The biggest thing is that the private equity firms need to assert themselves in these initiatives," says Groeger. "The portfolio companies will walk away, and nothing will happen without the push from the private equity firms. This can be an emotional issue, and portfolio companies can be reticent. The private equity firms really need to drive these initiatives."

Ultimately it is the portfolio companies' decision to join, and some portfolio companies learn the hard way that being part of the larger group would have had its advantages. For example, one portfolio company relied heavily on DHL for its shipping needs and was hesitant to join the private equity group's pooled purchasing program with FedEx. DHL was falling on hard times and abruptly stopped the company's pickup without notice. However, as a result of the private equity firm's relationship with FedEx, it was able to persuade FedEx to show up the next day and provide uninterrupted service to the portfolio company.

"You have to make a really good argument for not wanting to join. We have a responsibility to our investors to make the best decisions to drive returns from our portfolio," says Riverside COO Hendrickson.

### Add-on acquisitions are one place to spend

It's no secret that it's extremely difficult to get a deal across the finish line these days. That, coupled with the fact that many portfolio companies cannot count on organic growth in the near term, means private equity firms are looking more closely at strategic add-on acquisitions for their portfolio companies. (Figure 1.6) According to Thomson Reuters, in what could be a first for the private equity market, add-on deals represented more than half of all control-stake transactions closed in Q1 2009. (Figure 1.7)

Figure 1.6  
Deal type breakdown for Q1 2009

Response	Percent
Add-on	51
LBO	29
Public-to-private	8
Bankruptcy	5
Carve-out	3
MBO	3
Debt restructuring	1

Source: Thomson Reuters Buyouts

"The activity we are seeing is primarily coming from add-on acquisitions, which should help the outlook for portfolio companies," says Steve Brady, a Transaction Advisory Services partner with Grant Thornton. "Add-ons can add incremental revenue during this economic decline while, in many cases, reducing costs by using the platform company's overhead structure."

In Q1 2009, U.S. private equity firms closed 120 control-stake deals for a disclosed total of \$6 billion. Roughly 51 percent of all closed deals in the first quarter were add-on acquisitions. That's up from 33.8 percent in Q4 2008 and 39.9 percent in Q1 2008, according to Thomson Reuters. Add-ons have become more important to private equity firms' strategies for a number of reasons. First, there is availability. Given today's market conditions, many businesses are looking to shed non-core product lines and divisions, which can be picked up for bargain prices and don't come with the overhead that a whole company can have. The sellers are using the capital to pay down debt or are saving up dry powder for a rainy day. Secondly, with no debt available to private equity firms for platform acquisitions, the competition to buy some of these assets has dwindled considerably.

Figure 1.7

**Add-on acquisitions during Q1 2009**

Sponsor(s)	Add-on acquisition	Platform company	Industry sector
AEA Investors LLC	Little Hotties Warmers Inc.	Implus Footcare	Consumer staples
Atlantic Street Capital Management	Network Express Inc.	Ace Expeditors Inc.	Industrials
Austin Ventures LP	D&M Wire Rope Inc.	Delta Rigging Tools	Industrials
Bain Capital Partners LLC	Work Options Group Inc.	Bright Horizons Family Solutions Inc.	Consumer products and services
Battery Ventures	Insight Distribution Software	HighJump Software Inc.	High technology
Behrman Capital	Hardigg Industries Inc.	Pelican Products Inc.	Materials
Behrman Capital	Midwest BioResearch LLC	WLI Research Laboratories LLC	Consumer products and services
Berkshire Partners LLC	Eyeglass World Inc.	National Vision Inc.	Retail
Bertram Capital Management LLC	Xlibris Corp.	AuthorHouse	Media and entertainment
Carlyle Group LLC	EV Emprender	Orizonia Corp.	Consumer products and services
Carlyle Group LLC	Evare LLC	SS&C Technologies Inc.	High technology
Cerberus Capital Management LP	Imperial Group LP – Anniston, Alabama, Facility	North American Bus Industries Inc.	Industrials
Churchill Equity Inc.	SystemPlus Technology Pte Ltd	TSI Inc.	Media and entertainment
Circle Peak Capital LLC	VICORP Restaurants Inc. – Bakers Square Restaurants (4)	Shari's Management Corp.	Retail
Energy Investors Funds Group	NewPage Little Quinnesec Hydroelectric Facility	Northbrook Wisconsin LLC	Materials
Evergreen Pacific Partners LLC	MARCOR Remediation Inc.	Nuprecon LP	Energy and power
Falconhead Capital LLC	Denver Marathon LLC	Competitor Group Inc.	Media and entertainment
Golden Gate Capital	Applied Information Management Ltd	Aspect Software Inc.	High technology
Gryphon Investors Inc.	PRORehab PC	Accelerated Rehabilitation Centers Ltd	Health care
Gryphon Investors Inc.	Therapy Services of Iowa	Accelerated Rehabilitation Centers Ltd	Health care
Hellman & Friedman LLC	Jupiterimages Corp.	Getty Images Inc.	High technology
Huron Capital Partners LLC	O&P Professional Care	Michigan Orthopedic Services	Health care
JC Flowers & Co. LLC	Baden Retirement Plan Services LLC	Ascensus Inc.	Financials
Kelso & Co.	Foseco-Morval Inc.	Citation Corp.	Materials
Kohlberg Kravis Roberts & Co.	Jaybeam Wireless SAS	Amphenol Corp.	Telecommunications
Leonard Green & Partners LP	Art in Motion Income Fund	ICA Home Decor	Financials
Lindsay Goldberg & Bessemer	PNM Resources Inc. – Natural Gas Operations	Continental Energy Systems	Energy and power
Littlejohn & Co LLC	Helicomb International Inc.	Synchronous Aerospace Group	Industrials
Madison Dearborn Partners LLC	Muvico Theatres Inc. – Theaters (4)	Cinemark USA Inc.	Media and entertainment
Marlin Equity Partners LLC	HDM Corp – Qwik+Cross Medicare Crossover Business	Proxymed Inc.	High technology
Marwit Capital Corp.	R&L Inc.	Best Vinyl Inc.	Consumer products and services
Merrill Lynch Global Private Equity	Pizza Hut Inc. – Pizza Hut Units (51)	NPC International Inc.	Retail
Merrill Lynch Global Private Equity	Pizza Hut Inc. – Pizza Hut Units (55)	NPC International Inc.	Retail
Monomoy Capital Partners LLC	Citation Corp. – Aluminum Die Casting & Machining Operations	Compass Automotive Group LLC	Materials
Parthenon Capital LLC	American Stop Loss	AmWINS Group Inc.	Financials
Parthenon Capital LLC	Health Benefit Solutions Insurance Services	AmWINS Group Inc.	Financials
Parthenon Capital LLC	National Insurance Wholesalers	AmWINS Group Inc.	Financials
Pegasus Capital Advisors LP	Edison Group	National Strategies Inc.	Media and entertainment
Platinum Equity LLC	Integrated Labeling Systems Inc.	Peak Technologies Group Inc.	High technology
Platinum Equity LLC	VSC – Ryerson China Ltd	Ryerson Inc.	Materials
Resilience Capital Partners	Durakon Industries Inc.	Penda Corp.	Industrials
Rhone Capital LLC	Abieta Chemie GmbH	Arizona Chemical Co.	Materials
Riverside Co.	Horn Book Inc.	Media Source Inc.	Media and entertainment
Riverside Co.	Maos Co. Ltd	KK Shinsouki	Consumer products and services
RoundTable Healthcare Partners	ConvaTec Ltd – Unomedical Wound Care & Ophthalmics Business	Aspen Surgical Products Inc.	Health care
RoundTable Healthcare Partners	ExtruMed LLC	Vesta Inc.	Materials
Spectrum Equity Investors LP	Netupdate Inc.	Mortgagebot LLC	High technology
Thoma Cressey Bravo Inc.	Intraware Inc.	Acresso Software Inc.	High technology
Thoma Cressey Bravo Inc.	Software Techniques Inc.	Manatron Inc.	Consumer products and services
Trivest Partners LP	B&N Container Inc.	Box Board Products Inc.	Materials

Source: Thomson Reuters

Continued &gt;

Figure 1.7

**Add-on acquisitions during Q1 2009** (continued)

Sponsor(s)	Add-on acquisition	Platform company	Industry sector
Vector Capital	TallyGenicom LP – U.S. Assets	Printronic Inc.	Industrials
Veronis Suhler Stevenson	EnergyOcean 2009	Access Intelligence LLC	Consumer products and services
Veronis Suhler Stevenson	Offshore Communications 2009	Access Intelligence LLC	Consumer products and services
Vestar Capital Partners	PatientFlow Technology Inc.	Press Ganey Associates Inc.	Consumer products and services
Warburg Pincus	CastelMAC SpA	Braveheart Acquisition Inc.	Consumer staples
Warburg Pincus	Frimont SpA (Scotsman Industries Inc.)	Braveheart Acquisition Inc.	Industrials
Water St. Healthcare Partners	Stellate Systems Inc.	Alpine Biomed Corp.	Health care
Waud Capital Partners LLC	Option Care Northeast Ohio	CarePoint Partners LLC	Health care
Wicks Group of Cos. LLC	CBS Corp. – Radio Stations, Denver, Colorado (3)	Wilks Broadcast Group	Media and entertainment
Wynnchurch Capital Ltd	Bransam Logistics Services Inc.	Calyx Transportation Group Inc.	Industrials
Wynnchurch Capital Ltd	Kreative Carriers Transportation & Logistic Services Inc.	Calyx Transportation Group Inc.	Industrials
Wynnchurch Capital Ltd	Totalline Transport Inc.	Calyx Transportation Group Inc.	Industrials

Source: Thomson Reuters

“Private equity firms are looking closer at the risks involved and if the deal makes sense in the short term and the long term,” says Grant Thornton’s Brady. “The last thing portfolio companies need right now is an additional burden on cash flow. But in many cases an add-on acquisition can improve short-term performance and long-term growth.”

Many private equity firms are keeping busy just by completing add-on acquisitions. Since the credit crunch struck in 2007, Providence Equity Partners has completed a whopping 47 add-on acquisitions. Cliff Roesler, a managing director at W.Y. Campbell & Company, says that there is a decrease in deal activity overall but agrees that add-on acquisitions are more popular these days. “There is an excellent opportunity to consolidate market share for those who can survive,” Roesler says. “Valuations are low and, in reverse of recent trends, sellers are now considering contingent and deferred payments. At the right value, add-ons can help businesses regain scale, reach new markets and utilize overhead more effectively.”

Monomoy Capital Partners recently bought Global Thermoplastics, a manufacturer of engineered compounds for plastic molding applications. Global marked the fourth acquisition by Monomoy for its Fortis Plastics platform over the last eight months. “Add-on acquisitions make sense because they are low-cost and low-risk,” says Justin Hillenbrand, a principal with Monomoy. “The add-on companies are easy to get up to speed on because they’re in an industry the acquirer is already familiar with. Also, many of the add-on acquisitions are companies that would have otherwise been liquidated. So you are seeing a lot of companies grabbing market share by buying companies that wouldn’t survive on their own. The practice of completing add-on acquisitions is going to increase tremendously.”

Indeed, many private equity firms are aware that an opportunity to buy this cheaply may not be available again for some time. The best return on invested capital is often from acquisitions made during distressed times. Add-on acquisitions are being financed today in three basic ways: with asset-based financing, with excess cash on the portfolio company’s balance sheet, or with equity from the financial sponsors in anticipation of improved returns.

“We are playing the role of not just equity partner, but a capital source for our portfolio companies,” says Charles Santoro, a managing partner with Sterling Investment Partners. “We are providing our companies with financing because we realize they may be able to take advantage of opportunities in the marketplace that weren’t available in the past.”

**Many private equity firms are keeping busy just by completing add-on acquisitions.**

### The best use of human capital

Having the best human capital at your disposal is key to making any business successful. Unfortunately, as a result of the current market conditions, many private equity firms have had to make do with less. There have been layoffs across the board. It's no different at portfolio companies. As private equity firms performed cuts, portfolio companies were asked to take the same measures. "Cuts are just part of life right now," says one private equity professional.

With less human capital available overall and lower deal volume, private equity firms are bringing their expertise into the trenches. And cuts are just one of the reasons to bring in the help of a private equity partner. Another reason could be to give a portfolio company the extra support that can mean the difference between decent growth and large growth. For example, in January 2007, Sterling Investment Partners bought Fairway Market, then a four-store chain of high-quality supermarkets located in the New York metropolitan region. Sterling has been paying close attention to this company since buying it and has always had growth plans for the brand. Earlier this year, Fairway opened a new store in Paramus, N.J. With deal flow slowed and a new marketing person just joining Fairway, Amy Weisman, vice president and director of marketing at Sterling, was ready to pitch for the grand opening effort.

"Deal sourcing was down," says Weisman. "I had some extra time and the skills to help orchestrate this very big, important event for our portfolio company, so I went to work with them. I often worked in their offices and really took it to the next level. I helped on everything from brand development to commercials and billboard advertising. It was a great experience for me, and the management at Fairway really valued it."

With a successful grand opening that drew thousands of people to the event, including the governor, what effectively happened is that Weisman and the Fairway team set up a template for how to open their future stores. (Fairway is already set to open three more stores in the next couple of years.)

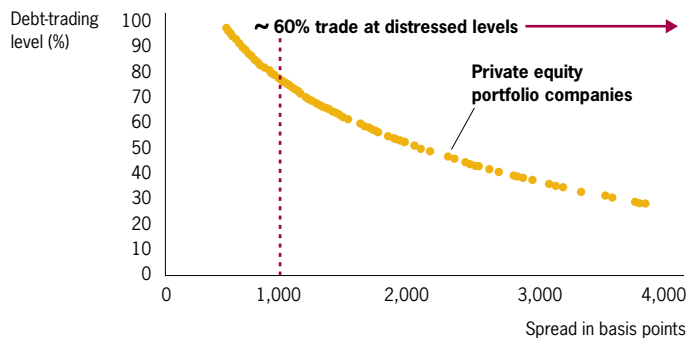
"Now is the right time to make sure you retain the best people working, even if that means reassigning people temporarily," says Brian Korb, a partner with Glocap Search. "That's why operational partners are still so much in demand. Being able to financially engineer companies isn't going to work these days. Private equity firms need people who have skills and are willing to roll up their sleeves and pitch in where necessary."

Indeed, a few of Madison Capital Funding's clients didn't have any operational capabilities and had no idea what to do when their portfolios started falling apart. They went to Madison and tried to push them to cut them a better deal. "Some sponsors have wasted valuable time trying to negotiate a financial fix versus focusing on the operations of their portfolio companies," says Christopher Williams, a senior managing director with Madison Capital. "We have had a few sponsors toss us the keys and walk away from businesses because they didn't have the operational expertise to deal with certain issues. As a lender, it makes you think twice about working with these types of firms. We have certain firms we won't work with because of this issue. There are other lenders that feel the same way."

Operational partners can make the difference between keeping a portfolio together and not. "There's no question that bringing in operational partners is a trend that's going to continue to increase," says Grant Thornton's Brady. "Firms that have operational partners, or advisors with industry experience, are going to be able to drive improved performance in the portfolio and be much more successful making acquisitions in a distressed environment."

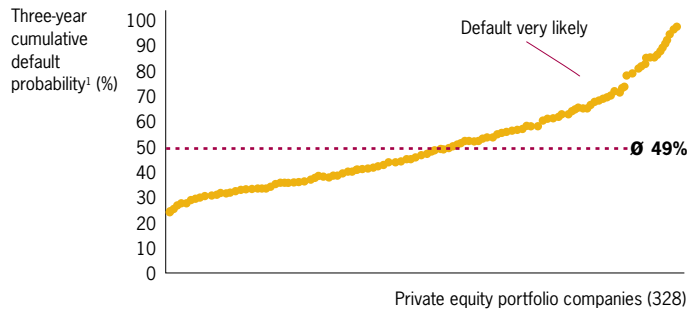
**Operational partners can make the difference between keeping a portfolio together and not.**

Figure 1.8  
**Roughly 60 percent of loans are trading at distressed levels**



Source: BCG-IESE data  
 Note: Trading levels and spreads for 320 portfolio companies

Figure 1.9  
**Almost 50 percent of portfolio companies will probably default**

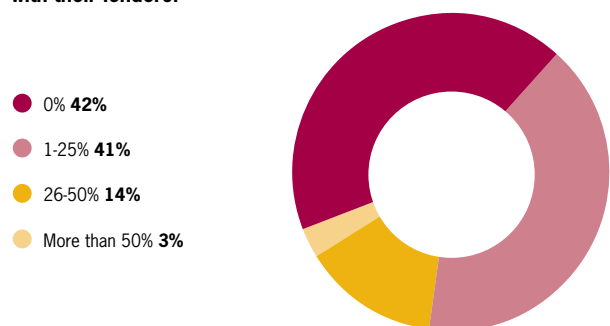


Source: BCG-IESE data  
 Note: Cumulative default probability for 328 portfolio companies  
<sup>1</sup>Defined as 1 - the product of the survival rates of the next three years, wherein the survival rate equals (1 - default probability) for the corresponding year. Default probability for each year is calculated as a credit spread / (1 - recovery rate) / 10,000; the assumed recovery rate is 40 percent.

### Renegotiating loan agreements

The strain portfolio companies are under is primarily the result of being overleveraged. Not surprisingly, more and more companies are expected to default on their debt through missed interest payments or covenants. At the end of last year, the Boston Consulting Group (BCG) speculated that roughly 60 percent of portfolio companies had loans that were trading at distressed levels and that almost 50 percent could default between 2009 and 2012. (Figures 1.8, 1.9) What’s more, BCG estimated that 40 of the top 100 global buyouts could collapse because of defaults on as much as \$1 trillion of debt. In addition, according to the DealMakers survey, 58 percent of private equity firms have some portion of their portfolio companies in covenant default with their lenders. (Figure 2.0)

Figure 2.0  
**What percentage of your portfolio companies are in covenant default with their lenders?**



Source: ACG-Thomson Reuters DealMakers Survey

“Many portfolios are hitting this point,” says one lender. “Private equity firms expected performance that just can’t be obtained in this environment. It is realistic to believe that half of all portfolio companies will be in default. No one likes to admit they are having problems, but every firm is looking at the debt they have on the books and trying to figure out a strategy for keeping their portfolio as healthy as possible.”

As a result, private equity firms are taking action, trying to negotiate better loan terms for their portfolio companies.

Look no further than the Chrysler situation to see that negotiation is in play these days. To avoid bankruptcy, Chrysler tried unsuccessfully to convince lenders to take \$6 billion of the \$7 billion it owes the banks in stock and the remaining \$1 billion in new secured debt. Needless to say, talks between Cerberus Capital Management, U.S. Treasury officials and a group of lenders — which included JPMorgan Chase, Citigroup, Morgan Stanley and Goldman Sachs — were intense but ineffective.

However, that is not always the case. According to Standard & Poor’s, there were 12 such debt exchanges last year, with eight taking place in December and six being negotiated by private equity-backed companies. Renegotiating terms gives borrowers clear benefits such as near-term liquidity, delaying maturity payments, reduced interest expenses and preventing covenants from being triggered, but S&P still views exchanges of distressed debt as equivalent to default because the issuer hasn’t met its obligations as expected.

During the first week of April alone, debt exchanges were the primary cause of defaults.

In 2009, notable debt exchanges included Freescale Semiconductors Inc. (owned by The Blackstone Group, The Carlyle Group, Permira and TPG), Ply Gem Industries Inc. (owned by Caxton-Iseman Capital) and Sensata Technologies Inc. (owned by Bain Capital). Another notable debt exchange was Harrah's Entertainment Inc. (owned by Apollo Management and TPG). The \$6 billion bond exchange in December 2008 reduced the gaming company's debt load by \$1.2 billion and extended its debt maturities to 2015 from 2010 and 2011. Private equity firms and investment bankers alike are optimistic that lenders are doing their best to try to keep portfolio companies from defaulting.

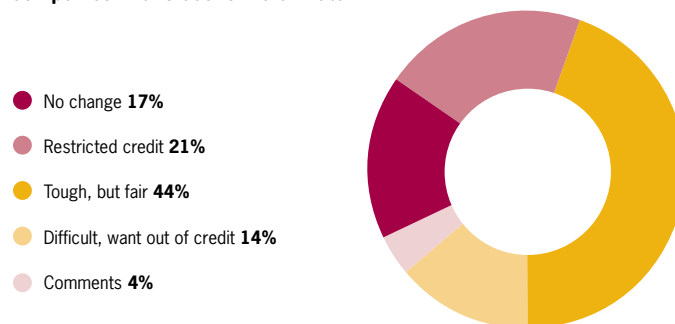
"There are situations that are beginning to emerge where banks are now making the decision to consider some form of conversion to more appropriately capitalize the business," says Santoro, Sterling managing partner. "Liquidation doesn't really benefit the lenders, and this is a constructive way to deal with the problem."

While lenders aren't thrilled to be renegotiating loan terms, many have little choice. A proliferation of defaults could topple lenders, many of which are already in a world of hurt from the subprime meltdown. Forgiving loans or adjusting terms gives lenders a better chance of collecting. And most private equity players understand this. (Figure 2.1)

"Without rapid recovery among lenders, companies must confront upcoming debt maturities and a lack of refinancing alternatives," says W.Y. Campbell Managing Director Roesler. "There are many loans maturing in the next 12 to 24 months and insufficient capital, or willingness, to extend or replace this debt. While lenders weigh their capacity to take over all these assets, borrowers are scurrying to propose consensual compromises that make sense. Initially, we believe most lenders will seek unachievable equity contributions and then opt for the safety of taking control. But we are hopeful consensual agreements will increase in frequency. As the results of recovery-through-sale attempts become better known, we think the quantitative evidence will weigh in favor of consensual solutions."

Figure 2.1

**How have lenders conducted themselves with regard to your portfolio companies in this economic climate?**



Source: ACG-Thomson Reuters DealMakers Survey

Madison Capital Senior Managing Director Williams says his firm and his peers will do everything in their power to keep the company in business, but they expect the sponsor to take a proactive approach as well. "Our first thought is, let's do everything we can to help the sponsor fix the situation. We never want to go into liquidation mode unless it's absolutely necessary. Maybe we will ask the equity sponsor to put in more equity to create liquidity in exchange for covenant relief or structural changes to credit. We have had a number of conversations like this. However, we expect the sponsor to be forthcoming and bring the issue to us early. Also, the sponsor can't just look at us for all the answers. Financial engineering by itself doesn't work. We need to see the sponsors making operational decisions to make their businesses stable," Williams says.

### Wait to negotiate

While many sponsors are looking for better terms, there are also a number that are trying not to open up a can of worms. "Some equity sponsors are finding that once they ask a lender to open up the loan agreement, everything is on the table, and lenders are trying to tighten up financing structures," says Ron Kerdasha, a group senior vice president with Cole Taylor Business Capital. "I am hearing of countless examples of lenders taking this position even if the borrower is seeking to finance a positive event. While acting in this manner may be justified due to the dramatic changes in the economy and the credit markets, asking lenders for help could cause sponsors to pay a higher price."

# Conclusion

There's no question that keeping portfolio companies alive is a priority right now. Sectors that are feeling the economic downturn the worst include retail, chemicals and automakers. According to Thomson Reuters, companies that are garnering the most attention these days (which suggests they are not caught up too badly in the economic meltdown) include industrials, consumer products and services, materials, high technology, energy, and power. And while no one can be sure that the market has bottomed out, it seems distressed investors are now poised for good investment opportunities.

Nevertheless, caution is of the utmost importance when investing in and dealing with portfolio companies in these uncertain times. Only when the macroeconomic environment begins to improve will private equity firms be in a position to make new deals. The markets are cyclical, and now is a great time for private equity firms to focus on their portfolios. Now more than ever, most private equity firms have both the knowledge and the time to create real value at the portfolio level.



**Caution is of the utmost importance when investing in and dealing with portfolio companies in these uncertain times.**

# Offices of Grant Thornton

## National Office

175 West Jackson Boulevard  
Chicago, IL 60604  
312.856.0200

## National Tax Office

1900 M Street, NW, Suite 300  
Washington, DC 20036  
202.296.7800

## Arizona

Phoenix 602.474.3400

## California

Irvine 949.553.1600  
Los Angeles 213.627.1717  
Sacramento 916.449.3991  
San Diego 858.704.8000  
San Francisco 415.986.3900  
San Jose 408.275.9000  
Woodland Hills 818.936.5100

## Colorado

Denver 303.813.4000

## Florida

Fort Lauderdale 954.768.9900  
Miami 305.341.8040  
Orlando 407.481.5100  
Tampa 813.229.7201

## Georgia

Atlanta 404.330.2000

## Hawaii

Honolulu 808.536.0066

## Illinois

Chicago 312.856.0200  
Oakbrook Terrace 630.873.2500

## Kansas

Wichita 316.265.3231

## Maryland

Baltimore 410.685.4000

## Massachusetts

Boston 617.723.7900

## Michigan

Detroit 248.262.1950

## Minnesota

Minneapolis 612.332.0001

## Missouri

Kansas City 816.412.2400  
St. Louis 314.735.2200

## Nevada

Reno 775.786.1520

## New Jersey

Edison 732.516.5500

## New Mexico

Albuquerque 505.855.7900

## New York

Long Island 631.249.6001  
Downtown 212.422.1000  
Midtown 212.599.0100

## North Carolina

Charlotte 704.632.3500  
Greensboro 336.271.3900  
Raleigh 919.881.2700

## Ohio

Cincinnati 513.762.5000  
Cleveland 216.771.1400

## Oklahoma

Oklahoma City 405.218.2800  
Tulsa 918.877.0800

## Oregon

Portland 503.222.3562

## Pennsylvania

Philadelphia 215.561.4200

## South Carolina

Columbia 803.231.3100

## Texas

Dallas 214.561.2300  
Houston 832.476.3600  
San Antonio 210.881.1800

## Utah

Salt Lake City 801.415.1000

## Virginia

Alexandria 703.837.4400  
McLean 703.847.7500

## Washington

Seattle 206.623.1121

## Washington, D.C.

Washington, D.C. 202.296.7800

## Wisconsin

Appleton 920.968.6700  
Madison 608.257.6761  
Milwaukee 414.289.8200



© 2009 Grant Thornton LLP  
All rights reserved  
U.S. member firm of Grant Thornton International Ltd

Document content is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information on the issues discussed in this document, consult your Grant Thornton client-service professional.

The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Grant Thornton International Ltd and its member firms are not a worldwide partnership, as each member firm is a separate and distinct legal entity.

In the U.S., visit Grant Thornton LLP at [www.GrantThornton.com](http://www.GrantThornton.com).