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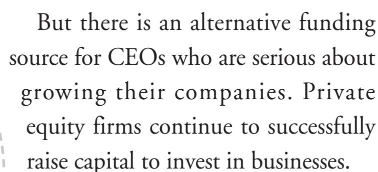
Private equity investments help companies grow during the credit crisis

By Tom Smith

As banks have tightened lending standards and scrutinized credit lines, even robust businesses have faced financial obstacles that may stymie growth initiatives well into 2009.

The reduction of available credit comes at a time when the economy is already struggling with a plummeting housing market, increasing unemployment rates and decreasing consumer spending. For many businesses, mounting turmoil in the credit market means a substantial increase in borrowing costs and possible postponement or even cancelation of expansion plans and hiring.



But there is an alternative funding source for CEOs who are serious about growing their companies. Private equity firms continue to successfully raise capital to invest in businesses.

THE CRUNCH CONTINUES

While the Federal Reserve has lowered interest rates aggressively to encourage the flow of money and spur economic activity, many financial institutions continue operating cautiously, holding onto their dollars while raising borrowing costs for corporations.

According to a recent Federal Reserve study, about 60% of domestic banks surveyed reported having tightened lending standards to large and middle-market businesses. In addition, 65% of banks said they had tightened their lending standards on commercial and industrial (C&I) loans over the past three months.

C&I loans are one of two vital forms of credit used by companies — the other being short-term commercial paper not backed by collateral. Collectively, these two types of loans dropped almost 3% over the last year — the largest annual decline since the credit tightening that began with the last recession in 2001.

These unfavorable conditions make private equity a particularly attractive financing option.

THE TRUTH ABOUT PE FIRMS

One of the most common misconceptions of private equity (PE) firms is that they are merely financial engineers looking to load their targets with debt, slash costs and then flip them for a quick profit. However, a recent survey from Ernst & Young suggests the opposite.

The report looked at metrics for the 100 largest private-equity exits worldwide in 2007 and compared them to the performance of comparable publicly traded companies over the same period.

The study found that companies sold off by private equity firms increased in enterprise value at an annual compounded rate of 24% during the time they were in a PE firm's portfolio, double the rate of the comparable publicly traded companies. Buyout firms also increased the earnings before interest, taxes, depreciation and amortization (EBITDA) of these portfolio companies 33% faster than their publicly traded counterparts did. Finally, these companies had productivity levels 33% higher than publicly traded company benchmarks.

The reason behind this outperformance is simple: disciplined PE firms focus their portfolio companies on specific initiatives to increase growth and improve margins. These efforts are all designed to create sustainable increases in the value of the companies.

According to the study, the key driver of growth was that more than half of the increase in EBITDA was driven by organic sales growth. This shows that PE firms aren't driving growth by cutting jobs. In fact, the study states that PE firms actually increase the number of employees 12% over the period of investment.

HOW PRIVATE EQUITY WORKS

There are many benefits to working with a PE firm, and many of those are amplified in less-than-ideal economies.

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Growth and expansion. Most PE firms invest capital in businesses, allowing them to enter new markets, expand product lines and purchase new equipment or otherwise foster growth. Business owners may be considering many of these moves themselves, but a lack of capital can stymie growth at even the best businesses, further supporting the benefits of partnering with a PE firm.

With help from the right PE firm, businesses can bring better systems into the organization that are designed to help with operational improvements such as reducing waste and improving throughput. Additionally, investments in technology and automation are common actions a PE firm takes to increase efficiencies and streamline processes, saving time and money on daily operations.

Globalization. A weak domestic economy brings an opportunity to enter and succeed in global markets. Companies operating overseas are well positioned to ride out a drop in domestic activity.

Private equity delivers the capital needed to take calculated risks, such as exploring new markets and expanding product lines to become a global player. Strong PE firms can also bring the knowledge and experience needed to build overseas operations and help companies take advantage of the currency exchange rate and economic growth in emerging markets.

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Strategic focus and experience. An outside PE partner's ability to take a step back and provide insight into a company's long-term strategic planning is another valuable benefit.

As businesses grow, they often take on new capabilities that may not be consistent with core competencies. Private equity provides access to industry expertise that helps a business sharpen its focus and channel growth into key areas that have the highest potential. The key is to use a PE firm's discipline and fresh perspective to help identify new markets and product opportunities that fit within the business' scope to boost competitiveness.

A good PE firm will work closely with the current owners and management to reach long-term, steady growth objectives, bringing in a level of industry experience and business knowledge that is invaluable.

Succession Planning. While strategic growth is often the paramount concern, more personal motives may also lead a company's owner to a private equity partnership or sale.

Many business owners lack a qualified successor and partnering with a PE firm may allow them to take a step back from day-to-day activities. After the transaction, business owners often stay involved as a board member. If the owner is looking for a strategic buyout, PE offers a way to keep the company out of competitors' hands while protecting its legacy. It can also create liquidity and help with estate planning and other personal financial issues.

MOVE FORWARD WITH GROWTH PLANS

Even though lending standards have tightened, and access to traditional financing has become more expensive, there are still options available to companies interested in following through with their expansion plans. Private equity firms pay fair prices and improve a business' operations, allowing for growth and continued success. CRW

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