

Welcome to this edition of Pilot's Log



Having entered the 4th quarter of 2009, market commentators remain uncertain when the market will improve. Sightings of 'green shoots' seem more wishful thinking than indicated by supporting trends. One thing is more certain though; the private equity world is forever changed, and from

this downturn will emerge streamlined (and fewer) players, more conservative deal structures, and more emphasis placed on good companies in good sectors with excellent management.

As PILOTpartners is solely focused on the private equity and change management world, it is not hard to imagine that we have a unique voice when it comes to seeing where the market is going. There is deal flow, although a mere fraction of where it was. Bolt-ons and roll ups continue to occur, albeit at a slower pace. Exits are taking place, though too often through administration and/or pre-packs. Even the banks are beginning to open their purse strings, even as they work through the first of several anticipated waves of over leveraged and under capitalized companies needing relief of one form or another.

Since establishing PILOTpartners in January, we have quickly had to adapt to the realities of the sector that we serve. We had anticipated that our business would be heavily reliant upon supplying interim executives, both to good and struggling companies, supplemented by fulfilling various permanent and non executive searches. Instead, due to deal flow having (mostly) dried up and sponsors having to postpone management changes until they've reconfirmed lender support (and reset covenants, etc.), a much higher percentage of our business has come from permanent and NED searches, as well as a huge increase in commercial due diligence projects.

Furthermore, the amount of work we are executing in Europe, Africa, and Asia almost exceeds that taking place in the UK. Much of this non-UK work is supported through the hard work, commitment and strong databases of our European affiliates.

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Corporate investors facing greater pensions risk Whether investing or divesting an investment, private equity managers must be vigilant in accurately measuring the pensions risk tied to the deal. Andrew Conquest, a partner in Grant Thornton's Pension Advisory team, outlines the current pressures

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In this edition of Pilot's Log Katherine Steiner-Dicks speaks with **Stephen Keating**, founder of private equity turnaround fund **Privet Capital**. Stephen offers his thoughts on the need for private equity to get back to improving businesses; getting hold of underwater stakes; why he is focusing solely in the

UK for deal opportunities and what he'd change about the private equity turnaround sector - if he could. [Page 4](#)



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Private equity backed retail group - PILOTpartners replaces the board PILOTinterim's client, a mid-market private equity firm, had invested in this £75m specialist retail business in 2007 as it had demonstrated solid, above average historic growth and needed an injection of capital to pay out the

retiring founder and to invest in an exciting, not to say ground breaking, new online business which eventually was expected to replace its high street presence. [Page 7](#)

Corporate investors facing greater pensions risk



Whether investing or divesting an investment, private equity managers must be vigilant in accurately measuring the pensions risk tied to the deal. **Andrew Conquest**, a partner in Grant Thornton's Pension Advisory team, outlines the current pressures of the pensions landscape and how these can affect an investor's obligations in a reorganisation or disposal.

The pensions landscape

The financial press is awash with headlines concerning the so called 'pensions crisis'. The paper headlines are fuelled by slow growth reports from the UK FTSE 100 paired with a UK pensions deficit on the accounting measure being close to £100bn, marking the highest deficit ever recorded. But when a more robust approach is applied (using gilt yields, rather than corporate AA bond rates) this figure would be more than double.

The wide variance between these two estimates highlights why most operators of defined benefit schemes are considering measures to mitigate pensions risk, with an increasing number closing schemes altogether. This is why potential investors need to be rigorous in their due diligence investigations into companies with a defined benefit obligation. However, when seeking to avoid these liabilities in a restructuring or altogether on an acquisition, there is limited scope, unless the employer is insolvent.

Acquisitions

In a defined benefit scheme, the risk of scheme assets not generating expected returns is borne by the employer, which can be faced with demands for significant increases in contributions. This can put a massive strain on businesses particularly in times of recession when revenues are under pressure.

In considering an investment in a corporate with a defined benefit scheme, potential investors need to be aware of the financial status of the scheme, the investment risks facing the fund, and the four main measures whereby future pensions liabilities are extrapolated. The main distinction between these measures is the degree of prudence that is applied in predicting future investment returns and how

these are reflected in the discount rates used to calculate the present value of future pensions liabilities. The main methods are:

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|---|--|
| IAS 19 /FRS 17 | Liabilities discounted by reference to AA rated corporate bonds. |
| Scheme specific funding- the funding target for schemes under the Pensions Act 2004 | Schemes set their own funding target according to the strength of the employer covenant. Liabilities are discounted at rates decided upon by trustees on the advice of the scheme actuary. |
| Section 179 | Liabilities are discounted at prescribed rates to estimate the cost of securing benefits under the compensation scheme operated by the Pensions Protection Fund. |
| Section 75 (buy-out) | The cost of purchasing annuities from an insurance company in order to secure the members' benefits. |

It can be expected that vendors will promote the IAS19 or FRS 17 valuation as being the most appropriate for valuing a business, but this will depend on good investment returns on plan assets being achieved typically over an extended period of time. The risk of those investment returns not being achieved lies with a purchaser. A significant over-valuation of a business could result unless more prudent discount rate assumptions are used in assessing future pensions benefits.

Opportunities on a restructuring

The Pensions Act 2004 introduced moral hazard provisions, whereby contribution notices can be issued against persons who are connected to the employer (which can include individual directors and shareholders), if there is an act or a failure to act which prevents the recovery of the Section 75 debt (the buy-out debt).

It is often the case that structural re-organisations and re-financing initiatives are implemented following the completion of acquisitions, particularly those involving complex groups of companies and multi-employer

schemes. The Pensions Regulator has recently issued a code of practice clarifying the circumstances in which a contribution notice can be issued. These include situations whereby sponsor support is removed or weakened, which might arise for instance if assets are transferred from a group company with an obligation to a scheme to one that does not, or if the group's assets are leveraged to generate finance for the acquisition.



Even the seemingly straight forward issue of transferring employees from one company to another can cause difficulties. If an employment cessation event occurs - for instance if a company which participates in the scheme is left without employees - its share of the overall buy-out deficit could be triggered for payment resulting in a strain on the group's resources.

A voluntary clearance process is available to shareholders, directors and other connected parties if it is recognised that a corporate transaction could be financially detrimental to a scheme. The Pensions Regulator can issue a clearance statement confirming that contribution notices will not be issued against the applicants. However, clearance will generally only be granted if mitigation is offered to compensate the scheme for the financial detriment it will suffer as a consequence of the transaction.

Disposals

The statutory regime governing contribution notices and clearance also applies to divestments. However, Contribution Notices and Financial Support Directions - an alternative remedy available to The Pensions Regulator - can be issued post divestment. Whereas a Contribution Notice can be issued against an individual, a Financial Support Direction can generally only be issued against a company. We have acted for trustees who have successfully argued that a scheme should be compensated for the payment of exceptional dividends several years beforehand.

Since the inception of the Pension Protection Fund (PPF), many owners of businesses have argued that their operations would be viable, if they could avoid legacy pension obligations and the attendant levies and expenses for defined benefit schemes. A range of reconstruction plans have been devised in order to demonstrate that it is in the best interests of all stakeholders if the PPF were to assume responsibility for the members' benefits emphasising that a reconstruction will help to secure the jobs of the employees.

Only a few of these reconstruction schemes have been entertained by the PPF, which can operate only within statutory constraints.

Such plans are only approved if they meet strict criteria set down by the PPF:

- The insolvency of the employer is inevitable.
- The reconstruction provides for a demonstrably better outcome for the scheme than is likely to be achieved if the employer fails.
- The scheme is being treated equitably with other creditors.
- Equity in the new operator of the business is provided to the PPF (between 10% and 33% depending on the circumstances).

Options to avoid deferred pensions obligations limited

The depth and strength of the anti-avoidance legislation is now so great that the options to avoid the deferred pensions obligation of a target are very limited. This will undoubtedly act as a disincentive to investment and result in a greater number of insolvencies of companies, which can no longer support their legacy schemes.

Profile: Andrew Conquest, Partner, Pensions Advisory, Grant Thornton

Andrew has specialised in treating ailing businesses since 1974. He was responsible for leading the firm's Recovery & Reorganisation practice in East Anglia for over 20 years before moving to London in 2000 to head up the London asset recovery and tracing team whilst playing a supporting role in Cambridge. His current role involves UK and international assignments in varying jurisdictions including the US, Ireland, Argentina, Romania and Scandinavia. Andrew leads our Exit Strategy product in London. He is also head of Recovery's haulage and distribution specialism and is responsible for liaison with our general practice team in the South East and Grant Thornton Dublin.

Q&A - Stephen Keating, Privet Capital



In this edition of Pilot's Log Katherine Steiner-Dicks speaks with [Stephen Keating](#), founder of private equity turnaround fund [Privet Capital](#). Stephen offers his thoughts on the need for private equity to get back to improving businesses; getting hold of underwater stakes; why he is focusing solely in the UK for deal opportunities and what he'd change about the private

equity turnaround sector--if he could.

How has deal flow changed since the credit crisis first took hold (around September 2008)?

It was still pretty slow in late 08 and early 09 – many of the opportunities that were around were poor businesses, which only needed a little push to tip them over. I saw more activity in June and July, most of which included decent underlying businesses, just not run as well as they could be, so fixable.

Do you always change management when you take on a new investment? If so, is sector experience more important than just using someone you know who has a successful track record, regardless of sector expertise?

I will almost always at least supplement management, and often make changes, but it's not a case of just getting rid of them all. Going through a crisis usually needs extra resource, so some of the extra help is relatively short term, to implement the changes to turn the business around.

The right experience varies between situations and roles. Some sectors need specific knowledge (such as retail), although there is usually good knowledge within the business below main board level. Otherwise, I think turnaround skills are applicable across most businesses – the basic approach of learning how a business makes money and applying common sense. I also think there are roles in which sector experience is not necessary, for instance finance.

Which sectors are you most keen to follow for distressed deals?

I'm looking at all sorts, and am more focussed on whether I can work out what's gone wrong and how to fix the business rather than specific sectors. Having said that, you won't be surprised to hear that I'm seeing lots of consumer facing businesses, such as retail and leisure. I think there

are attractive opportunities if you pick the right ones, possibly with further bolt-on acquisition opportunities over the next one to two years.

Do you think that there is profit in bundling up other private equity firms' underwater assets as opposed to waiting until they are either ready for pre-pack or go bust?

I haven't seen many private equity houses ready to let go that easily yet. If there is no current value, then selling doesn't help if they're trying to realise cash. If they believe in the business they may spend time on it themselves, and if not, it's probably the bank's problem. Some of the poorer performing investments have been bundled up with better ones though – there are some specialist funds doing this, like Vision and Coller.

In principle, getting hold of underwater stakes could be interesting as it would get you a seat at the table, allowing you to bring new money and negotiate a restructuring from the inside, which is a good place to do it from. I can certainly see this happening on a deal by deal basis – we've looked at some – and I expect it will develop as a technique.

Do you look outside the UK for deals, especially in countries even worse off than the UK for example Eire or Spain?

No – there's plenty to do in the UK!

Do you think that the private equity business model has changed forever? Will the UK asset class shrink back to those who are prepared to go back 20 years and/or do solely equity deals?

Private equity is still a relatively young industry and continues to evolve. I am a great believer in the private equity ownership model, where professional investors act as owners of a business – this brings focus and professionalism to the running of a business. However, for the last few years it has been too easy to make money by just the financial engineering – actually adding value is harder work. Private equity does need to get back to improving businesses, which is about operations and strategy rather than funding structures.

If there was one thing you could change within the private equity turnaround sector, what would it be?

That's tricky, and anything I say will probably sound self-serving. It's a very small sector at the moment, with different models being put to the test, for instance the balance of skills required, so it will evolve quite quickly I think. More broadly, there are elements within the sector, like the Institute for Turnaround, trying (and succeeding to an extent) to make our voice heard in and amongst the noise and political positioning. So, if there is one thing, maybe it's that appropriate weight is given to the views of those who are directly involved in turnaround, rather than it being driven by media hype. We can dream I guess!

Overcoming cross border challenges



Cross border investment opportunities are becoming more attractive as companies are more likely to come on the selling block at realistic prices than be revived through a refinancing. **Gordon Clark** lends his insight and experience on how to successfully disseminate the cross-border deal process rather than throw in the towel when things start to look tough.

Having worked on cross-border projects covering Europe, the US and Japan over the past ten years the one thing I have learned (with scar tissue to prove it) is that there ain't no such thing as a single management solution. This is regardless of sector, as the same rule held true rather whether the project was in automotive, telecoms, consumer or even industrial products.

Surprisingly, basic management disciplines hold good whether the involvement has been hands-on control of a major restructuring or turnaround, operational appraisal of multiple sites targeted for acquisition by a private equity house, or facilitating a logical, but sensitive, joint venture.

However, 9 times out of 10 core controls are missing or left so weak that they are no longer useful for the basis of a clearly defined strategy or the management of the business. It seems that business momentum driven by market demand and seasoned heavily with executive complacency will produce numbers that prove impossible to sustain.

Rapid, rigorous analysis of key financials and their underlying drivers is vital, but rarer than one might think, leading to poor due diligence and investment valuations. Also, market and operational assessments, in parallel with the numbers investigation, are core to painting an accurate picture of the target company.

The current state of the financial markets brings the added complication of multiple lenders, credit insurance and other financial instruments and the attendant covenants aggravated by the absence of new money. These elements must be clarified if any kind of deal is achievable.

Separating fact from fiction

In cross-border, multi-site businesses it is vital to unravel any underlying and unnecessary stumbling blocks. These could include local management fiefdoms; claimed customer preferences on products and pricing whereby local salesmen can be very creative in promoting 'customer demands'; and interpretations of trade and employment legislation. This tangled web has to be unravelled quickly and decisively. Objective early stage reviews of these elements must include separating fact from fiction; defining the true core business profile. This process seems obvious, but is often delayed until after the deal is done.

Radical organisation change in the first stages of an acquisition can be problematic and introduce another complex variable to the development of the business. Bring the key managers together to develop the forward strategy and respect their inputs. Decide early on as to whom you will entrust the financial controls, an existing manager/director or a proven outsider.

A combination of group and local incentives will make clear the company expectations of the senior national executives. A willingness by group senior management to communicate directly to each site ensures that a preferred common message is spread as the keystone for further dialogue with employees.

Where confidentiality agreements allow, initial dialogues with customers help triangulate the internal commercial claims of the sales strategy and tactics.

Overriding legislation from say, the EU, can come a poor third place behind national interpretations of the same laws and the power of the local mayor.



In countries such as Belgium, Italy, France and Germany (in that order), there are stringent processes in play designed to ensure that company owners and managers communicate clearly and regularly with employees on a broad range of matters affecting the business, especially where restructuring and redundancies may result. Attempting to avoid or unilaterally circumvent the process will lead to disaster and loss of management control. Start by defining the process and be prepared to seek pragmatic compromises to reduce timescales and mitigate cost.

Is there ever a project too difficult?

If the above issues guide you towards placing a possible investment project in the 'too difficult' box then that would be understandable, but perhaps erroneous.

All of them have occurred before and have been resolved using appropriate management expertise and professional advisers. The timescale to complete a deal may prove to be longer, but the outcome can be no less valuable. Deal with the combined local components thoroughly to achieve a group solution. Entry pricing should reflect the complexity of the initial deal and the exit returns may take longer to obtain, but discipline and patience can bring very acceptable outcomes.

So where do you spend the money languishing in your investment funds? If I knew that I would be a very rich man. However, cash more than ever is king. Portfolios are coming to the point where sale is more likely than refinancing and prices should be well below those prevalent in the feeding frenzy of recent times.

Good hunting.

Gordon Clark is currently Director of Reviver Limited.

Gordon, a fluent French speaker, has more than 25 years experience turning around under performing organisations and guiding others through growth and expansion. Examples of achievements on projects include creating and executing a marketing strategy that ignited sales from £100m to £190m in three years, which generated further growth to £250m over the next five years; and motivating sales growth for another project from £40m to £200m over a five-year period while securing contracts that continued growth to £300m over the next five years.

Gordon can be contacted on 07801 064 850

CASE STUDY

Private equity backed retail group - PILOTpartners replaces the board



PILOTpartners client, a mid-market private equity firm, had invested in this £75m specialist retail business in 2007 as it had demonstrated solid, above average historic growth and needed an injection of capital to pay out the retiring founder and to invest in an exciting, not to say ground breaking, new online business which eventually was expected to replace its high street presence.

The management team had been retained and a new non executive chairman was appointed by the investor who “had done a good job” in another investee business outside the sector.

18 months later the business had burned its online development budget, had made no impact in terms of market share and shareholder value had been decimated, admittedly in the face of the severity of the recession impacting in a niche segment of the retail sector involved in products which were luxury and/or “not must have” items. And the bank covenants were about to breach on a number of fronts.

One would have expected most experienced retailers to have seen this coming, more or less, and made a good stab at making whatever operational changes were necessary. In this case, in retrospect, having achieved the buy-out and the capital injection required to achieve their business dream, the management seems to have gone to sleep and waited for the market to come to them. Retail never works like that. Customers voted with their feet.

First of all, their patience exhausted and, in common with some other investments they had made in 2006-2007 with hefty debt multiples, the investor decided that the root cause of decline was that their choice of chairman was responsible for not focusing the team hard on the agreed buy-out strategy and in particular the phasing of the new online service. In short, he simply had not managed the board properly, relying on management and technical reports as received without the requisite analysis and scrutiny...without asking the difficult questions.



So the appointment of a new Chairman was seen as the catalyst for significant change and for the restoration of value over an extended investment timetable. James Wheeler of PILOTpartners was engaged to source a shortlist of three sector specific, interim turnaround chairmen – first to advise the investor on the art of the possible, how to handle the bank and then to look at the options for a realistic recovery. The interviews were held and the preferred interim chairman started work straight away.

Within three days the extent of the management team’s failure had become all too clear. The chairman reported:

- The technology platform for the online project was clearly flawed but could be resolved quickly. The project had been outsourced and no director was prepared to stand up and be counted for its failure.
- The CEO had been in the business for many years, was seen as an industry guru whose word was gospel and was therefore rarely challenged. Questions were now being asked.
- The finance director appointed at the LBO was technically gifted but had little experience of cash & currency management and his forecasts were always going to be some distance from reality. He needed to be replaced. The controller was competent.
- Merchandising was universally from the Far East. The buying team had been paying over the odds for years, there was no currency hedging policy (see CEO & FD above). The relevant director (with a fancy job title) responsible was bright enough but needed turning round.
- Margins arising from the online business should have been much higher than its high street equivalent; the reverse was the case. The sales director needed to go.
- There had been no investment in the warehouse to cope with customers converting to online purchasing.
- Staff morale was becoming a real issue, their working environment almost 19th century.

That was in June 2009. The chairman's recovery plan was quickly agreed with the investor:

- The bank agreed to covenant relaxation – at a price.
- The chairman hired PILOTpartners to replace the finance director and sales director in week 3 with proven retail sector expertise. These appointments are working out very well.
- An interim buying specialist and a supply chain/ operations manager were hired to support the merchandising director with the fancy title.
- The CEO was given some time to redeem himself and to take responsibility for the implementation of the recovery plan changes under the chairman's eagle eye. Sad to report that this hasn't worked out well and he is now being replaced by one of the sector's best known interim executives until a permanent post holder can be hired some time after the Christmas/New Year period on which the business relies for some 45% of annual sales.
- An interim warehouse manager has just started to take responsibility for getting goods out to customers in time for Christmas...
- The business is back on track.

(No apology is made here for anonymity even though naming names would be more fun - all PILOTpartners clients and interim executives expect total confidentiality unless agreed otherwise and this is no exception)

Continued from Page 1

During the 3rd quarter of 2009 PILOTpartners handled 61 assignments covering interim management, interim to permanent and non executive appointments, and commercial due diligence - 22 of which involved UK and US capital invested in Europe. We've also been finding other ways to support our clients, with initiatives ranging from co-hosting MBI candidate dinners, to introducing sector experts to various firms.

For the 4th quarter and heading into 2010, from our perspective we do expect to see market improvement across the board. Inquiries started picking up their pace during the 2nd quarter, followed by increased opportunity flow in the 3rd. And this is not just in the distressed market. Investors are ever more focused on the need to sharpen up the management teams of portfolio businesses, from Chairman, to Logistics Director. In the distressed market there are a number of factors which give us cause to expect even more work this side of Christmas / New Year – HMRC is becoming more aggressive / less benign; retail is expecting to have a really tough time; restructurings will have to continue to work without bank cash; there must be a limit as to how many more debt for equity deals the banks will accept.

PILOTpartners will also be shortly making a few big announcements, so please continue to watch this space.



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