

CREDIT WEIJI: GENUINE CRISIS OR TIME FOR OPPORTUNITY? - ARAOZ & RUEDA

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In the late 1950s, President JF Kennedy said that 'When written in Chinese, the word crisis (wēijī 危机) is composed of two characters: one represents danger, and the other represents opportunity.'

Despite the efforts of linguists and writing theorists to clarify that in Mandarin a weiji is indeed a genuine crisis, a dangerous moment, a time when things start to go wrong, a critical or crucial point and not an opportunity, since that speech given in Indianapolis, this presumed oriental wisdom is erroneously used by many politicians, popular press and financial gurus to communicate the inspirational notion that a crisis should be a time of optimism and a juncture when one goes looking for advantages and benefits.

Francisco Aldavero, socio especialista de capital riesgo del bufete Araoz y Rueda, analiza las oportunidades y dificultades relacionadas con las operaciones de inversión de capital riesgo (CR) en

el presente clima económico. A pesar de la crisis, las sociedades de CR continúan captando nuevos fondos para invertir. Pese a que los precios de las posibles operaciones están bajando rápidamente, sin duda resulta difícil determinar el valor actual de una empresa u obtener un apalancamiento favorable para financiar una transacción. Otra preocupación es que la salida exitosa de un fondo por medio de una OPV no resulta factible por el momento. Por lo tanto, quedan dudas sobre si la crisis crediticia está apoyando o perjudicando a los venture capitalists. En opinión del autor, ha llegado el momento de desdeñar los riesgos y de ejercer la prudencia.

The managing partner of one of Europe's biggest private equity and venture capital (PE) firms recently said that after the golden age of the period 2002-2007, the PE industry will now spend a year or so in 'purgatory' before entering an even greater period of expansion, or *platinum age*. The discussion underlying this opinion is whether the credit crisis is helping or hurting private equity and venture capitalists.

On the positive side, it is a fact that many PE firms have raised billions of euros in new money within the last two years and all of which is ready to be invested in a deflationary environment in which prices are plummeting.

Another positive factor is that PE is a long-term asset class and any changes to the sector will take time to turn around. In other words, unlike hedge-fund managers, PE capital is locked up for a long period of time.

In addition, the origin of PE funds usually shows a reasonable balance between debt and capital at the corporate level, something that allows these firms to expand into new opportunities while investment banks and other financial players are shrinking or shutting down.

Based on the foregoing, a very optimistic observer would conclude that the present situation is one of the severe adjustments that happens from time to time with no long-lasting effects on the PE industry.

However, there are some areas of concern that should be analysed to reach a more realistic approach. I will just refer to two of them, although it would be quite easy to increase the list substantially:

I) *Divestments*: With an adverse economic environment, past flows of acquisitions will reduce dramatically until the credit market recovers or prices go down. Potential buyers may not obtain the necessary financing or find it is prohibitively costly for a target business whose value has been calculated with pre-crisis criteria. That means that the PE's returns may be affected in those cases where the PE needs to divest as the investment cycle comes to an end.

Furthermore, the stock market turmoil, including the evolution of the share prices of the eleven companies that went public in Spain during 2007, goes in parallel with the evolution of the credit markets and explains the IPO drought for 2008. Although IPOs have been an emerging exit route for PE investments over the last three years, it seems it will take some time before PE players may (generally) benefit from this route again.

II) *Portfolio companies*: Many of the big LBOs (leveraged buy-outs) completed by PE firms in the last four years used heavy leverage. Those target companies having a solid capital structure will have time to ride out the storm but others could be adversely affected by a slowdown in the real economy and the difficulties in maintaining their credit lines. On top of that, banks and credit entities will monitor more closely and more rigorously compliance with solvency and debt covenants and this will imply an extra pressure that may distract management from the day-to-day business and frustrate many built-up projects.

It is true that in spite of the ongoing credit crisis, opportunities for PEs in the financial services sector remain compelling. However, it may still be a time of prudence as the most recent experience on the

credit crisis shows that a feel-good attitude toward adversity may not be the most rational, or realistic approach to its solution.

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