

Building up business in the recession



Although valuations are down and lending is more expensive, there are still opportunities for businesses to create value in the current climate, says Andrew Harrington of AHV Associates.

Over the last six months, mass media despair has given the impression that the financial system is no longer functioning, the banks are not lending and that money is very difficult to get at any price.

Happily, the situation was never as bad as this and it has recently been improving. As a corporate financier in the small to mid market, I am exposed to banks and investors on a daily basis and think it is important to clarify the state of the financial market for accountants who are advising clients on how to build value in the real economy.

There is money available

It is clear from my dealings with banks that there are considerable funds still available, although admittedly there isn't as much debt available as in the boom years. About a third of the total lending capacity of the market has been withdrawn by international banks looking to limit their exposure, but the good news is that UK banks are actually lending more than they did in 2008.

These banks are also using this opportunity to increase their margins. With any technical breach of covenants resulting in a change in terms, it's no surprise that banks are now trading profitably. However, it is also no surprise that many marginal deals that were previously done due to the abundance of cheap debt are now being rejected (this mostly refers to the larger, multi-billion pound deals that were agreed based on cheap debt structures).

One must also not forget the contribution of equity investors. Equity investors typically include venture capital trusts (VCTs), venture capital funds and private individuals (via EIS or directly). These investors have raised money in the past two years and are actively looking to invest (or they will have to return these funds to their investors). I estimate VCTs may have up to £400m available, while uninvested VC funds raised in the last two years could be at least another £500m.

Also adding to the amount available are government backed initiatives announced as part of its attempts to kick start the economy, e.g. the 75m Capital for Enterprise Fund announced in January 2009.

What investors are looking for

Stricter lending terms and the requirement to identify low risk opportunities has led investors and lenders to be more selective as to the type of companies/investment propositions they look at.

Businesses with the following characteristics are typically getting funding or lending on reasonable terms:

- Recurring revenues
- Recession resilient industry (this does not necessarily imply total resistance, but a proven capacity to weather the storm should be evident)
- Broad range of customers
- Good track record and a solid future growth strategy

It is true that most new money will go to these types of companies and that other types of companies will find it more difficult to obtain funding, but there is still money available to various other businesses evaluated on a case-by-case basis. Below I will attempt to outline what this means for your clients.

Thinking of selling a company

Recent developments in the market have had significant effects on company valuations. As can be expected, valuations are typically lower than they were a year ago. This is due to the increased price of funding (whether it be debt or equity) and weaker economic conditions, which have a direct impact on company forecasts. Valuation multiples should improve as the economy recovers.

Furthermore, the profits on which the multiple is applied should be higher. This means that it often makes sense for vendors not to sell their businesses at present unless there is a good reason. These reasons could include:

- Retirement sales
- Exit for some shareholders or those looking for a reduction in their personal risk
- The business needs to be part of a larger company in order to accelerate growth
- Management wish to undertake a buy out in order to execute a credible growth strategy that will take advantage of current conditions and accelerate growth

There are a number of active acquisitive investors in the market including trade buyers and financial investors with debt and equity still available to support them if necessary. However, each transaction should be structured to provide additional benefits to the vendor in anticipation of economic recovery. This would usually require an appropriate combination of cash, equity and loan notes.

Making acquisitions

The market is full of good companies available at cheaper prices than a year ago. However, really cheap companies are usually distressed and firms should only pursue an acquisition strategy if it fits in well with an overall business strategy such as broadening a product range or customer base and gaining scale. Capital is available to support acquisitions for good sponsors and a sound strategy.

We have seen many companies looking to solve a financial problem by making use of an

acquisition strategy. This is definitely not advisable, especially in a market where debt and equity finance is expensive and the economy is in recession.

Restructuring debt

All lenders are taking a tougher stance on companies that breach debt covenants (no matter how technical the breach is). The penalty for a breach can be higher interest rates or one off fees and may result in a loan being called in. Any negotiation or extension of debt facilities will result in worse terms for the borrower.

It is important for clients to understand their options before entering into negotiations with a bank. Often the bank is in a substantially weaker position than you may think and it is therefore crucial to seek advice in advance of discussions with the banks which could prevent a major impact on the businesses' equity value.

It's not as bad as you think

Although valuations are down and lending is more expensive, there are clearly opportunities to execute the right strategy in this market as long as you remain informed and are aware of the position of the banks and equity investors.

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