

Investment Firms: Managing Through and Seizing Opportunity in the Economic Crisis

As the global economy continues to slide more deeply into recession, with entire sectors under pressure to restructure, investment firms will need to redefine their management agendas if they are to survive the downturn and achieve success in the future. Oliver Wyman has identified areas of critical importance: redefining focus within the investment cycle, realigning portfolio holdings, and enhancing portfolio company performance through improvement initiatives and restructuring. In each of these areas, as described herein, there are specific steps investment firms can take to enhance their business designs, improve their investment decision making, and strengthen their portfolios to not only ride out the current financial crisis but prosper in the recovery.



The current global economic crisis and pressure on company valuations are creating new challenges for private equity firms, sovereign wealth funds, and other investor groups across the globe. Credit tightening is making deal completion more difficult. The stock market and valuation declines are intensifying focus on portfolio companies. Demand shortfall and changing customer preferences are impacting portfolio company performance. And even more fundamentally, the lingering global recession casts a cloud of uncertainty across the financial community.

Market conditions have changed more rapidly in 2008 than we have witnessed in recent times. The economies of Europe and the United States are in recession and Asian nations, including the remarkable growth engine of China, are seeing growth declines. The Middle East is not immune from the current turmoil, but might benefit from the upside sooner than Western economies. While there are challenges, the Middle East, with its investment capital resources, its young, growing population, and its strategic position between the West and Asia, could be well positioned to seize the opportunities created by the current economic transformation.

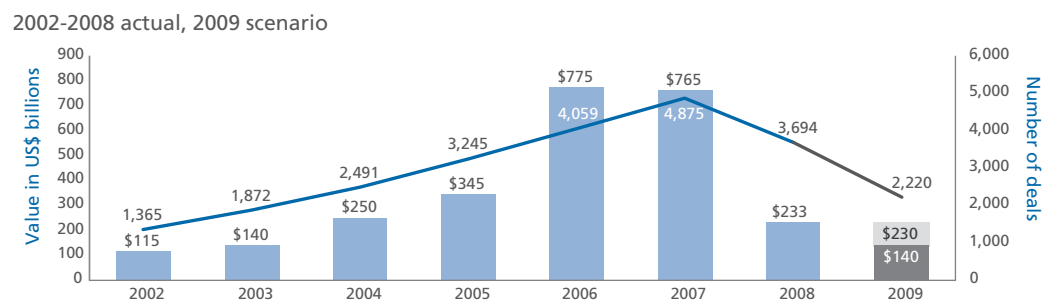
Entire sectors of economies are drastically changing and restructuring. New players, new technologies, and new ways of doing business are emerging to serve a world with ever changing demographics and customer requirements. The future calls for new priorities and decisive actions.

Winning investment firms will drive a redefined agenda in 2009; specifically, redefining the focus within the investment cycle, realigning portfolio holdings, and enhancing portfolio company performance through improvement initiatives and restructuring actions when conditions warrant.

Redefining Investment Lifecycle Focus

Transaction volume dropped significantly in 2008 as the ability to consummate deals became more difficult. Private equity related transaction volume (in terms of number and value) enjoyed tremendous growth over the five-year period from 2003 to 2007, but realized a major decline in 2008 that is expected to continue into 2009. In most recent surveys, the vast majority of PE professionals anticipate a drop in investment in 2009. In that context, the most bullish scenario would not predict a level of PE activity above the 2008 level at US\$230 billion, but on the contrary a conservative view could picture activity at the 2003 level in the US\$140 billion range (Exhibit 1).

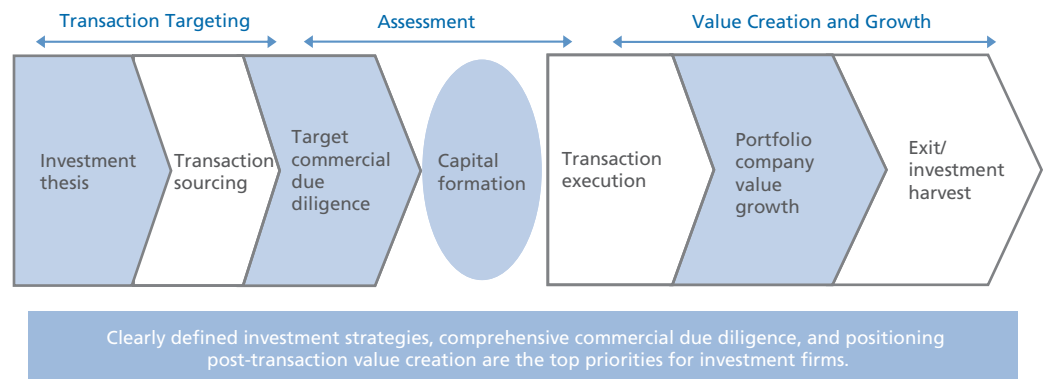
Exhibit 1 Global private equity M&A activity: Annual transaction value (US\$ billions) and number of transactions



Source: 2002-2008: Thomson Reuters. 2009 scenario assumes same average deal size (US\$63 million) with a decline rate in transaction volume of 40 percent from 2008.

Even with lower valuations and PIPE investment opportunities, fewer deals are foreseen on the horizon because of less debt being available, the result of tightening credit markets and a reduced supply of buying opportunities as sellers wait for a market rebound. These forces have caused priorities across the investment lifecycle to change significantly (Exhibit 2). The winning firms will have business designs that select the best industries and geographies as part of their investment strategy formulation, conduct comprehensive due diligence in the deal assessment phase, and improve each portfolio company's performance in the post-transaction environment.

Exhibit 2 Investment transaction lifecycle

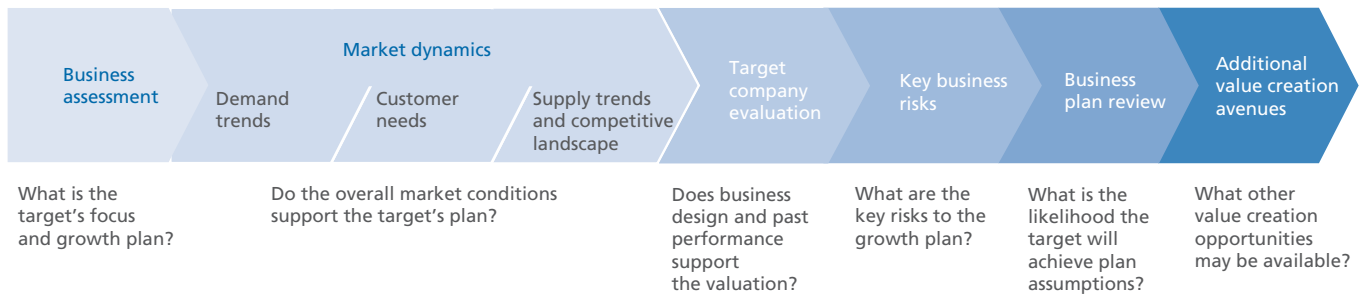


Investment theses and strategy formulation requires new thinking. The generalist approach to geography and industry will likely no longer be effective. With greater competition for fewer deals and increasing seller sophistication, the investment firm will need to have a more focused strategy in the geographies and industries where it operates. Geographic expertise is of critical importance in emerging markets and local knowledge is essential to consummate deals successfully.

As the strategy of investment firms continues to adapt to the changing marketplace, it is likely we will see industry specialization as a point of differentiation. Selecting specific industries to target—and understanding industry risk-return profiles, market and customer trends, and winning business designs within sectors—is now a necessity for successful investment. Different sectors do not have the same investment return profiles, and so the ability to create value enhancement in the portfolio company requires specific deep industry expertise.

Commercial due diligence—evaluating the target company's markets, strategy, and business to ensure sound investment decisions and post-transaction value growth—is also a key ingredient to make certain the company business design is positioned for emerging and future market conditions (Exhibit 3). To attract debt financing to the deal or justify low-leveraged buyouts, the potential investor must ensure the target company has a unique and differentiated value proposition to satisfy customer requirements, has sustainable market share, and financial forecasts are reasonable and attainable. Additionally, post-transaction value creation opportunities and tactics should be clearly identified during the commercial due diligence process.

Exhibit 3 Commercial due diligence

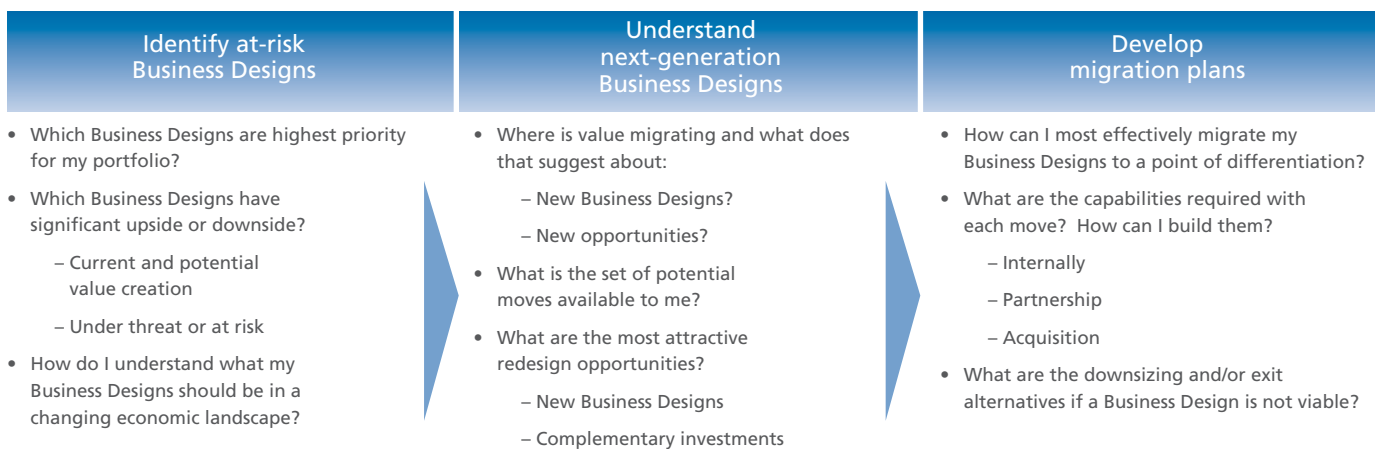


Realigning Portfolio Holdings

A top priority for the established investment fund is to reevaluate its existing portfolio companies in light of the new market realities. As market demand and customer requirements have been altered by the recent economic turmoil, the portfolio may require strategic realignment and holdings rationalization. Those portfolio companies that produced robust returns in the past likely may not achieve required returns in the future.

Winning investment firms will proactively determine which core portfolio companies to retain and invest in, and which to restructure or divest. A structured and objective approach should be deployed to assess continued investment choices and business redesign options. As outlined in Exhibit 4, identifying at-risk business designs models, understanding next-generation business designs, and developing actionable migration plans should be the basis of portfolio realignment efforts.

Exhibit 4 Portfolio business design review



Portfolio Company Performance Improvement and Restructuring

The portfolio companies need to have comprehensive business planning and management capabilities to successfully execute strategies and improve financial performance. Financial engineering is no longer adequate to ensure satisfactory returns, but rather sound portfolio growth and management must take on greater importance. It will be critical for investment firms to actively work with their portfolio

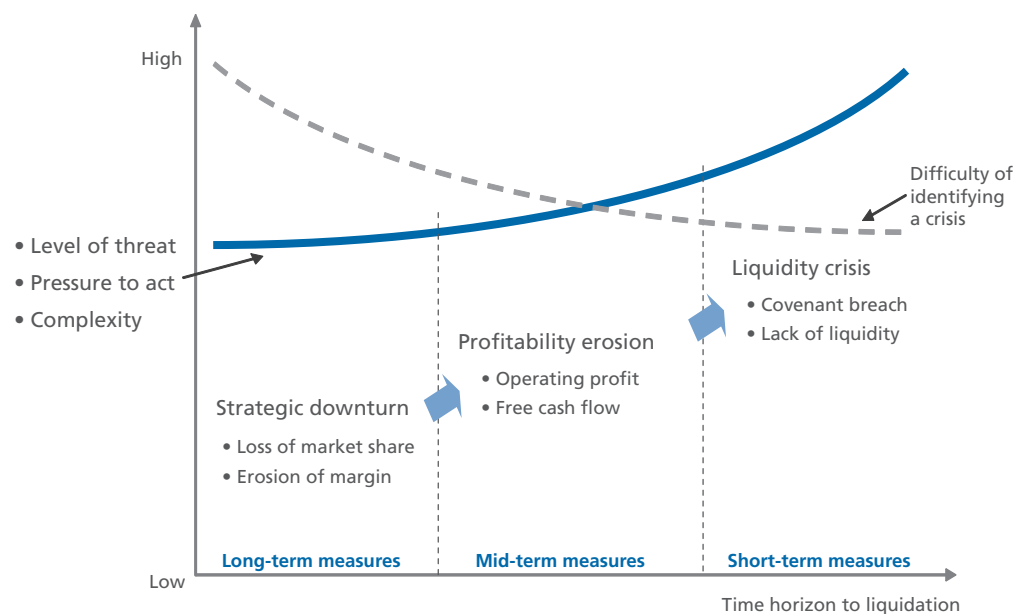
companies on executing improvement agendas to ensure adequate profitability, cash flow, and return on investment. The agenda may include improvement initiatives in areas such as:

- Business model redesign
- Business planning and reporting
- Sales and marketing effectiveness
- Supply chain optimization
- Cost structure optimization and outsourcing
- Operational and productivity improvement
- Organization effectiveness and capability development

Prioritizing and applying resources to improvement efforts should be based upon value creation potential, with speed to implementation being the highest focus.

In some cases, however, where a portfolio company's expected performance does not provide acceptable returns, more structural and urgent restructuring actions may be warranted. The overnight sea change in capital markets is making refinancing more difficult and further investment by the existing shareholders may not be attainable. Additionally, market demand shortfalls, higher operational risks arising from customer default and supplier terms, and an excess fixed cost base may cause a company's strategic and profitability issues to lead to an all out liquidity crisis (Exhibit 5).

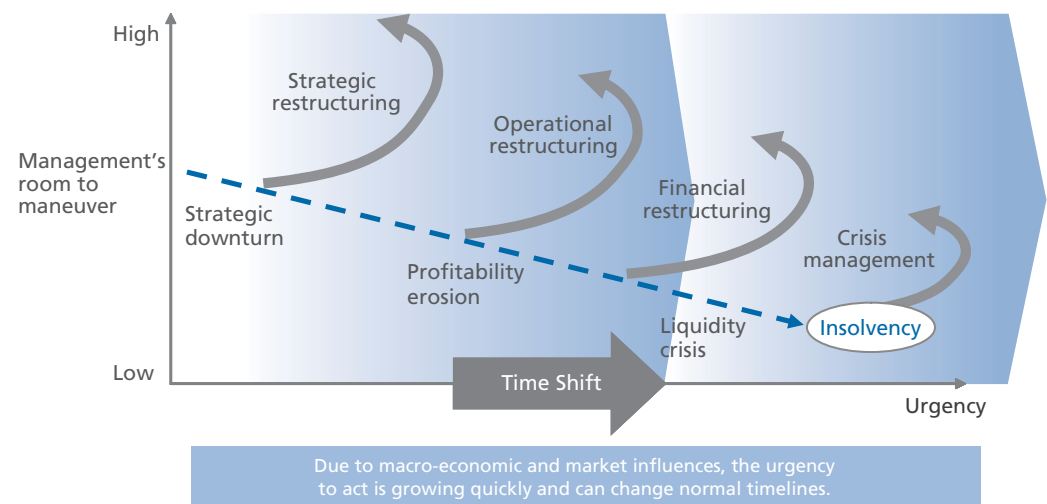
Exhibit 5 Performance crisis: Knowing when to act



Companies that normally would have time for considered measures to resolve strategic and profitability issues are finding that timelines to act are greatly compressed and pressure to make fast decisions intensified. With little room to maneuver, portfolio company managers can find themselves rapidly overwhelmed by a crisis, as they focus on putting out fires and calming panicky stakeholders, while lacking the time and support to undertake essential but more complex restructuring (Exhibit 6).

A crisis situation requires much more aggressive and prompt actions, where traditional performance improvement efforts will not suffice. In the restructuring environment, investment firms should work closely with portfolio company senior management on short-term stability and longer-term viability: Buy time and space to avoid insolvency, through actions that rapidly increase liquidity and reduce cash burn. Deploy strategic, operational, and financial restructuring to secure long-term optimal outcomes.

Exhibit 6 Anatomy of a crisis: The squeeze on management



The year 2009 will have challenges but will also offer significant investment opportunities. Investment firms will need a redefined investment strategy around investment theses to identify winning opportunities, robust commercial due diligence to make the right target investment decisions, and intensified efforts to improve portfolio company performance. Geographic focus, industry expertise, and hands-on value enhancement will continue to rise in importance, and will in many cases separate the winners from the losers. ❖

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