BUYOUTS 4

From the earliest modest takeovers of the 1960s to the mega-deals of recent years, buyouts have accounted for the majority of the capital invested globally by private equity funds. Racking up both spectacular successes and headline-grabbing failures, buyout firms have been viewed with either admiration or trepidation by investors, governments, regulators, and the media.

The public perception of buy-out transactions is cyclic; waxing and waning with the prevailing macroeconomic environment or one's ideological position. However, control transactions undeniably provide the levers to radically re-engineer a business and drive change across all aspects of an investee company. And they can measurably impact the economy at large.

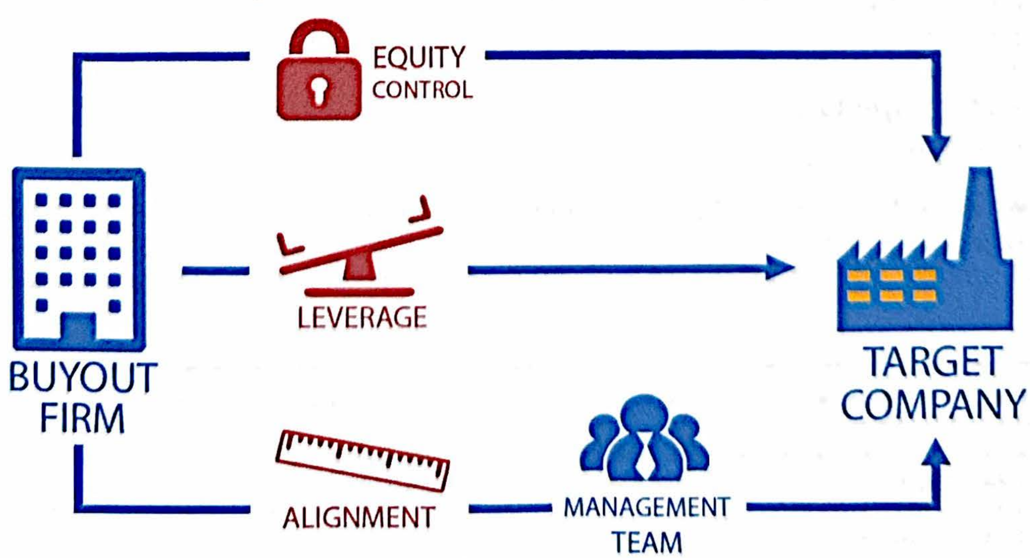
This chapter first defines the three essential components of a buyout and then analyzes a typical funding structure in leveraged buyouts (LBO).[1] It goes on to examine the principal stakeholders in various types of buyouts and concludes with an overview of the common buyout strategies.

BUYOUTS DEFINED

Buyout funds acquire controlling equity stakes in companies that allow them to restructure the targets' financial, governance, and operational characteristics. However, despite this control element, buyout investors must work proactively with a wide range of stakeholders—from management to debt providers—to execute on their investment thesis by driving value creation in their portfolio companies.

Three components define a buyout strategy: equity control, leverage and economic alignment. Each of these levers, shown in Exhibit 4.1, provide buyout funds with ways

Exhibit 4.1 Defining Characteristics of Buyouts



1. For the sake of simplicity, we will use the terms "LBO" and "buyout" interchangeably.

to influence strategic and operational decision-making at the target to maximize their return on investment.

EQUITY CONTROL: In a typical buyout, the PE fund will control a majority of the economic and voting interests in the portfolio company. A controlling interest does not necessarily imply 100% ownership of shares—in fact, in certain circumstances it may even be less than 50%—but rather that the buyout fund has the right to dictate strategic and operational decisions via the board of directors. In the case of a minority stake, de facto control can be obtained through a coalition of like-minded investors or specific provisions in the shareholders' agreement.

Control allows a buyout fund to apply leverage to a company's capital structure, expand or replace a portfolio company's management team, restructure its governance and reporting structures, drive operational improvement, and professionalize the overall business throughout the holding period. Control is crucial when it comes to exit planning, as buyout investors can initiate the necessary governance upgrades, ensure strategic alignment and authorize additional spending if and when required to optimally position the investee company for sale.

Given those advantages, acquiring a controlling interest in a company frequently commands a higher price ("control premium"), especially in the case of take-private transactions of publicly listed companies.[2]

LEVERAGE: Most buyouts are structured as LBOs, with a significant portion of the transaction financed through debt. A portfolio company's capital structure post-buyout will typically consist of 50–75% debt, with equity funding the balance.[3] The debt capacity of a target is a function of several factors, including the stability of cash flows across an industry, the target's ability to generate cash flow from operations (i.e., its cash conversion rate), market conditions and the buyout investor's reputation (i.e., as a borrower in earlier deals). During the investment process, buyout funds analyze a range of operating scenarios to optimize the amount of leverage applied in a transaction, thereby considering various downside scenarios and ways to reduce the risk in an investment.[4]

Assuming a fixed purchase price, the primary benefit of leverage is the ability to achieve higher returns on the buyout fund's equity stake. Leveraged capital structures increase an investor's return on capital by reducing the amount of equity required to fund its transactions. However, due to the competitive nature of most sales processes, the benefit of a leveraged transaction accrues to a large extent to the seller, as it allows the buyer to offer a (higher) purchase price that would be impossible to reach without debt.

So while the benefits (mostly) remain with the seller, the buyer faces the other side of the coin, namely, the increased cost and strong cash flow required to service the debt (both annual interest payments and debt repayment). These obligations make the

2. Please refer to Chapter 8 Deal Pricing Dynamics for additional information on deal pricing and public-to-privates.

3. The original buyout transactions in the 1980s employed higher leverage ratios, sometimes as high as 90% or more. As the PE industry matured, the amount of leverage applied in buyout investments dropped and settled at a generally lower level. In some jurisdictions new regulations have made the use of leverage beyond a certain point less economical.

4. Please refer to Chapter 7 Target Valuation for additional information on optimizing the funding structure in a buyout.

portfolio company more susceptible to external shocks, thereby increasing the risk of financial distress or even bankruptcy.

The impact of a highly leveraged capital structure is not entirely negative: the increased risk of financial distress following an LBO has been shown to have a disciplining effect on management. Debt servicing requirements reduce the free cash flow available for capital investment and force management to prioritize high net present value projects.[5]

Finally, the covenants associated with debt financing introduce a monitoring and early warning system to identify lapses in company performance. The breach of a covenant triggers a range of remedies to protect the debt holders' economic claim on a portfolio company, giving them an opportunity to take action before the viability of the business is at risk.[6]

ECONOMIC ALIGNMENT: The ability to align the economic interests of its portfolio company's management team with that of its fund is a key driver of PE's success in buyouts.[7] The management compensation plans used provide senior executives with meaningful equity stakes in the target company and substantial upside in the event of a successful exit. These plans typically require a significant personal co-investment from each participating executive. With managers participating in a buyout as owners, a PE fund's goal of maximizing financial return is thus shared by those in charge of executing the fund's investment plan and managing the day-to-day operations at the portfolio company.

While the structure of these compensation plans magnifies management's potential returns on the upside, it comes with risks. A management team's "sweet equity" and stock options produce a return several multiples of that realized by the PE fund, should an investment perform as planned. However, in the case of a poorly performing business, management's co-investment is at risk of being wiped out, as their equity stake is often subordinated to that of the PE fund. In such a scenario, the PE fund's equity stake will typically retain some value and claim 100% of the proceeds to equity shareholders given its preferred position in the capital structure.

LEVERAGED BUYOUT FUNDING

In an LBO, buyout investors combine their fund's equity capital with debt capital raised from a range of lenders to acquire a target company.[8] While the specific instruments employed vary deal by deal, typical LBO financing consists of senior debt, junior debt and equity capital.

5. Debt has been found to make managers risk averse in the face of bankruptcy risk.
6. Please refer to Chapter 9 Deal Structuring and Chapter 10 Transaction Documentation for further details on bank financing and covenants.
7. Please refer to Chapter 12 Securing Management Teams for a detailed example of management incentive structures.
8. Please refer to Chapter 9 Deal Structuring for additional detail on LBO debt instruments.

Exhibit 4.2 Sources and Uses of Funds in a Buyout

SOURCES		USES	
Senior Debt	450.0	Purchase Target Equity	550.0
Junior Debt	200.0	Refinancing Net Debt	430.0
Equity	350.0	Transaction Costs	20.0
Total Sources	1,000.0	Total Uses	1,000.0

The capital is used to fund the acquisition of the target company's equity, repay a target's existing net debt and cover fees and expenses associated with the acquisition. Exhibit 4.2 shows a simplified example of the sources and uses of funds in a buyout.

SENIOR DEBT: Senior debt is typically issued by one or more banks and represents the largest portion of debt raised for an LBO. This class of debt is the least expensive source of long-term financing as it has a priority claim on the company's assets in case of bankruptcy; it is typically "secured" against specific company assets, further strengthening senior debtholders' bankruptcy rights. It typically has the shortest term (five to eight years) among all debt instruments, pays an annual cash coupon and comes with the most stringent debt covenants in the capital structure. Senior debt is often raised in multiple tranches, one of which is amortized through annual repayments (with any balance due at the end of the loan's term); the remaining tranches are repaid in a single bullet payment at maturity.

JUNIOR DEBT: Junior debt accounts for the remaining debt capital in a buyout; the most common forms are mezzanine financing raised in the private institutional market and high-yield bonds raised from the public bond markets. This layer of debt is unsecured and subordinated to senior debt in the event of bankruptcy. Junior debt instruments have longer maturities than senior debt (eight to ten years), pay annual cash interest and may in some cases accrue additional non-cash interest; they are typically repaid via a single bullet payment at the end of the term.

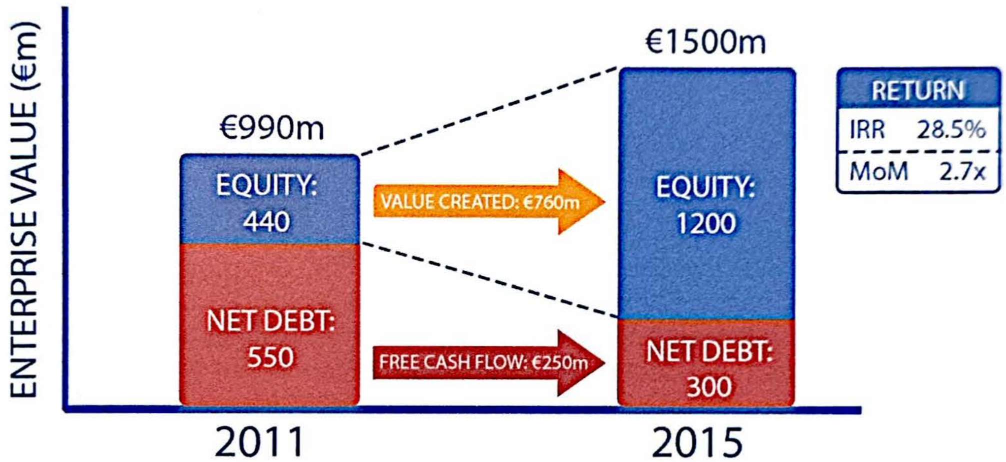
EQUITY CAPITAL: Equity capital typically accounts for 25–50% of LBO funding. The equity portion of a buyout may be sourced from a single buyout fund or a consortium of funds, management team members, and LP co-investors. Equity is the most junior funding instrument, with only a residual claim on operating cash flow and company assets in the event of bankruptcy or restructuring. The equity in a buyout is often divided into a preferred share class or shareholder loan (typically accounting for the majority of equity capital invested), and common equity. A PE fund will usually hold the vast majority or all of the preferred shares, while management will own a significant portion of the common equity.

Box 4.1

BUYOUT VALUATION AND VALUE DRIVERS

This example explains the mechanics of a "standard" LBO and illustrates value creation at both the company and equity level. It shows how returns can be broken down and attributed to the various basic value drivers in a buyout[9] (Exhibit 4.3).

Exhibit 4.3 Buyout Valuation and Return



ENTRY		EXIT
€110m	EBITDA	€150m
9x	EV MULTIPLE	10x
5x	DEBT MULTIPLE	2x

Let's assume a PE fund acquires in 2011 a company with €110 million in earnings before interest, tax, depreciation and amortization (EBITDA). The purchase price (enterprise value) has been negotiated and agreed to be €990 million, representing a multiple of 9x EBITDA. As typical in an LBO, a substantial amount of the purchase price is financed by debt, about 5x EBITDA or about 55% of the purchase price, while the remainder is paid for with equity.

Over the next four years, the company grows its EBITDA at an annualized rate of about 8% to €150 million. Crucially, over the same period, the company generates €250 million in free cash flow (after investment and after financing cost) allowing the owners to repay some of the debt.

With a better performing company at hand (and maybe with the benefit of a generally improved economic climate) the PE fund is able to sell the company at a multiple of 10x EBITDA in 2015. After subtracting the remaining debt from the enterprise value of €1.5 billion, the value of the equity amounts to €1.2 billion or 2.73x the invested capital. For a holding period of four years, this equates to an internal rate of return (IRR) of 28.5%.[10]

9. Please refer to Chapter 13 Operational Value Creation for more on attributing operational value-add.
10. The simplified calculation does not include transaction cost on entry or exit.

It is worth noting that the enterprise value over this period has "only" grown at about 11% per annum, clearly demonstrating the effect of leverage on the returns in buyout deals. Overall, €760 million in equity value has been created, through the contributions of the value drivers shown in Exhibit 4.4.

Exhibit 4.4 Buyout Value Drivers

CREATED VALUE	=	EBITDA IMPACT	+	MULTIPLE IMPACT	+	NET DEBT IMPACT
€760m	=	€360m	+	€150m	+	€250m
(100%)	=	(47%)	+	(20%)	+	(33%)

In this case, 47% of the equity value came from EBITDA growth (calculated as [Exit EBITDA minus Entry EBITDA] × Entry Multiple), 20% from multiple expansion (calculated as [Exit Multiple minus Entry Multiple] × Exit EBITDA and finally 33% from net debt reduction of €250 million.[11]

A Differentiated Approach—Buying Right and Creating Value Early

By Andrew Sillitoe, Co-CEO, Apax Partners LLP and a Partner in the Tech & Telco team

There are two distinct approaches to LBO investing that can be seen in the market, firstly paying up for sustained growth and secondly an approach that can be referred to as "buying right and creating value early."

The first approach essentially offers only one value creation lever—EBITDA growth. This approach can lead to inflated entry prices, justified by ambitious, high-growth five-year business plans that forecast acceptable IRRs, but that often result in less reliable, back-end loaded returns. The high multiples paid, often when too much capital is chasing too few deals, mean buyers effectively spend the first two years, the most predictable in a buyout, running hard to stay still, having acquired investments at values that have already factored in the profit improvement over this period. This situation can get even worse if markets correct. This undermines the potential to generate returns over the first two years and pushes any return drivers to the, inherently less reliable, later years.

The high multiples paid reduce significantly the chances of multiple expansion and the effects of deleveraging are also likely to be minimal, given the large

11. This breakdown does not attribute any of the improvement in multiple and debt paydown to the underlying EBITDA growth.

amounts of equity and debt used to finance the acquisitions. The reliance on one, back-end loaded driver of returns may lead to a significantly higher risk of disappointment and investments skewed to the downside.

The second approach of "buying right and creating value early" involves staying focused on entry multiples, rather than IRR models, buying assets at or below their intrinsic value, and finding opportunities where value creation can be engineered through the operation of multiple levers early in the life of an investment. Executed well, this approach creates an early margin of safety, with the focus on moderate entry multiples providing greater protection if asset valuations show a sustained downward move and, conversely, an opportunity for multiple expansion if conditions are benign.

These opportunities can be found more readily by shunning mainstream assets and by forming differentiated and sometimes contrarian views. This differentiated approach to investing is not easy to execute and can sometimes mean taking other forms of risk, albeit ones that are inherently more controllable. It requires three key conditions to be met:

1. The availability of a rich pipeline of differentiated opportunities
2. The ability to make judgements to avoid the pack
3. A toolkit to transform businesses

Differentiated Opportunities

The strategy requires discipline and the resolve to say "no" frequently. It requires a rich pool of opportunities from which to select and sector expertise to generate a quality and differentiated deal flow. This approach also benefits from a global footprint, which can enhance opportunities for value arbitrage, offer potential for global expansion (either organically or through M&A) and optimize exit opportunities.

Avoiding the Pack

Sector expertise is critical, both at the macro level to enable a focus on subsectors which are underappreciated, and at the micro level to find individual companies that have often been overlooked. This requires a skill to look beyond the obvious to find opportunities which are less "picked over," taking differentiated and, sometimes, contrarian views.

A Toolkit to Transform Businesses

Ensuring a business is led by the most effective senior team is priority one. The operational skills of private equity firms should therefore be designed to help strong management teams maximize a business' potential through specific functional expertise; strong management teams don't require general management advice, they require partners that will help them solve critical business issues. Gaining alignment around the transformation program pre-deal is critical to ensure that this program begins on day one.

In essence, identifying good opportunities to buy right and create value early means being able to differentiate between great assets and great investments.

The industry needs to guard against becoming too price-insensitive for supposedly stable assets, making it ever more critical to source differentiated opportunities, execute robust value creation strategies and unlock hidden value—the keys to generating enduring, absolute returns.

MANAGEMENT TEAMS IN A BUYOUT

A strong management team is a key ingredient to a successful buyout. As controlling shareholders, buyout investors have full discretion to choose the teams they work with. A close cooperation between management and the respective partners at the buyout firm is vital to ensure both a smooth acquisition process as well as productive engagement post-acquisition. Depending on how active the role of the management team is during the acquisition process, one can distinguish several types of buyouts, namely, management buyouts (MBOs), management buy-ins (MBIs), and institutional buyouts (IBOs).[12]

MANAGEMENT BUYOUT (MBO): In an MBO, the incumbent management team initiates the buyout of a company or corporate division with the financial backing of a buyout fund. This arrangement allows PE firms to capitalize on the management team's knowledge of the target company and provides a distinct advantage relative to other interested parties. An MBO can be particularly attractive when management, given its familiarity with the business and established relationships with internal and external company stakeholders, wishes to capitalize on new growth opportunities. The acquisition process is often led by the management team with the buyout fund providing, primarily, capital and some of its structuring expertise as a repeat buyer. While successful MBOs provide management teams the opportunity to work in an entrepreneurial environment with greater rewards, failed MBO attempts may lead to alienation between senior management, existing owners and company staff.

MANAGEMENT BUY-IN (MBI): In an MBI, a buyout fund partners with an external management team to pursue an acquisition of a portfolio company. If successful, new management with an equity stake in the firm will replace the incumbent management team. Typical MBI targets have sound growth potential and the right business model but may lack effective management. Buyout firms often work with successful management teams on multiple MBIs, benefiting from an established working relationship. On the downside, MBIs often require a longer due diligence period as the buyout fund cannot leverage the insights of existing management; in addition, possible conflicts between the new management team and existing employees may need to be addressed.

INSTITUTIONAL BUYOUT (IBO): In an IBO, the buyout is initiated by a PE firm without the support of the incumbent or external management team. Rather, a buyout fund negotiates directly with the seller, with little or no support from any management team until the acquisition terms have been agreed. The buyout fund may decide to retain existing management, replace the management team or selectively augment an existing team with new talent for specific roles once the transaction has been finalized. IBOs are by far the most common form of buyouts in mid-sized to large transactions.

12. In addition to the three main types of buyouts discussed in this section, various combinations of the three strategies can be employed. For example, in a 'buy-in management buyout,' the existing management team is bolstered by new team members and partners with the PE sponsor on an acquisition.

TYPES OF BUYOUT TRANSACTIONS

Buyout firms target businesses with diverse forms of current ownership such as privately held, stand-alone businesses, publicly listed companies, divisions of large corporations, and assets sold by government entities. While businesses targeted for an LBO typically generate consistent annual cash flow for debt servicing and have a strong market position, value creation levers available to the buyout fund often vary depending on the target's origin. The following section describes some of the most common strategies employed by buyout funds, the type of businesses targeted and common value creation levers applied.

PUBLIC TO PRIVATE: Publicly listed companies are often acquired in public-to-private (P2P) transactions, also known as take-privates. The principal motivation for taking a company private lies in reduced agency risk—resulting from the often tenuous alignment of interests between public shareholders (the principals) and company management teams (the agent)—under a single owner and the implementation of a governance structure that increases accountability of the management team (Exhibit 4.5). In addition, delisting a business eliminates the costs associated with public reporting and the focus on short-term, quarterly earnings in a publicly listed business, freeing management to focus on long-term value creation. Taking a business private also allows a company to carry more leverage. A PE firm's conviction in the value creation potential is reflected in the (at times large) premiums paid by PE funds to delist businesses.

Exhibit 4.5 PE Value-add: P2P

CARVE-OUT: Buyout funds often acquire a corporate division, business unit or subsidiary and set it up as a stand-alone company. It makes for a viable strategy for business units that, for example, are no longer core to a company's strategy or that were unsuccessfully integrated during a corporate merger or acquisition (Exhibit 4.6). These divisions often do not receive adequate attention from top management, appropriate funding or talent relative to other more dynamic business units, and may be structured in a suboptimal way due to a bloated cost structure or inexact allocation of overhead expense. In carve-outs, PE firms principally unlock value by developing a robust strategy for the new, stand-alone company, establishing governance and control systems and providing adequate funding to expand business operations.

Exhibit 4.6 PE Value-add: Carve-out

PRIVATIZATION: Government privatization programs provide a rich source of targets for buyout funds. Significant value can be unlocked in state-owned institutions by updating the company's business model, reducing cost inefficiencies systemic in the public sector, providing fresh resources for growth and focusing management on profit maximization; non-financial goals traditionally pursued by state-owned businesses may be sacrificed in the process (Exhibit 4.7). PE firms can also add value by replacing dated decision-making processes with an updated governance structure that empowers employees throughout the organization.

Exhibit 4.7 PE Value-add: Privatization

FAMILY BUSINESS: Privately owned family businesses[13] are a popular target for buyout funds, as external management teams installed by a fund can rapidly professionalize a business and drive value creation (Exhibit 4.8). As decision-making in family businesses often rests with a single founder or a core group of family members, updated corporate governance measures, including the establishment of a formal advisory board with

13. Family businesses often use buyouts as a viable succession option.

independent directors, can help remove biases related to personal relationships and introduce checks and balances at appropriate levels of the business. PE firms can create value by leveraging strong brands and relationships built under family ownership, or by updating legacy strategies and focusing on cost reduction. It is important to note that positive attributes of a family business, such as close networks, a strong company culture or the loyalty of employees to the family, are sometimes diluted under the new ownership.

Exhibit 4.8 PE Value-add: Family Business

SECONDARY BUYOUT: Portfolio companies controlled by another buyout fund are frequent acquisition targets and such transactions are referred to as secondary buyouts. The principal opportunity to add value here is through strategic realignment (Exhibit 4.9). Although the exiting PE firm has likely capitalized on a range of value creation opportunities, the acquiring PE firm may bring a unique combination of skills, knowledge and in-house networks to drive new strategic initiatives at the company. In the case of a prior LBO, these targets have "proven" their ability to service debt, and current management has experience running a levered business; therefore, a larger proportion of debt financing can often be secured for a secondary buyout.

Exhibit 4.9 PE Value-add: Secondary Buyout

CLOSING

Mention PE and audiences will often think of buyouts first. Indeed, buyouts make up the largest (in dollar terms) and often most visible part of all PE transactions and constitute a sizable portion of all mergers and acquisitions. Defined in the early years by their aggressive use of debt, buyout funds have long become smart operators, increasingly driving value creation in their portfolio companies with the help of operating partners. The governance mechanisms that are central to their business model include full equity control and interest alignment with management and will be the focus of distinct chapters later in the book.

KEY LEARNING POINTS

- **In a buyout, PE investors acquire a controlling equity stake in a target allowing them to make all financial, strategic and operational business decisions.**
- **Management teams execute the investment strategy of the fund, making it paramount to create an incentive scheme that aligns the interests of management and PE owners.**
- **Most buyouts are structured as LBOs with debt financing a large portion of the acquisition price.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #11: Chips on the Side (A): The Buyout of Avago Technologies

Case #13: Going Places: The Buyout of Amadeus Global Travel Distribution

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