Private Equity

2015

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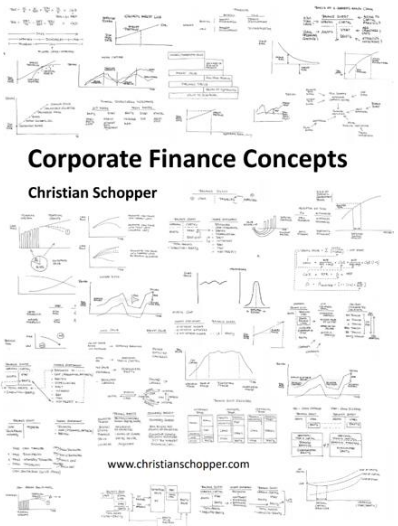


Introduction

- Although private equity (PE) has been around for many decades, today many billions of dollars have been invested in large, leveraged deals, changing the ownership and financial profile of some large companies

- The PE industry operates within an infrastructure of financiers and supporting professionals

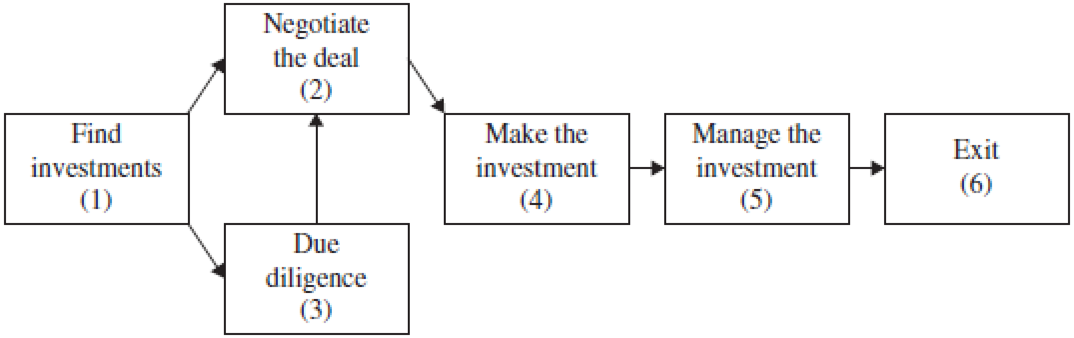
- It works by financing its acquisitions largely through debt, owning the businesses for a while, and then selling them on at a profit

- The lack of constraint by public markets and a closeness of the PE owners to the management and the business mean that it is possible for the PE company to add value to its investment at the negotiation stage, during the ownership period and on the eventual sale

Private Equity Companies

- PE companies raise funds and invest them in businesses with the **aim of increasing** the **value** of those funds many times over
  - The PE companies make money out of this, and also from the fees they charge their investees
- The PE companies can obtain their funds on stock exchanges, some are "captives" - investing the money of their parent companies -, and some are independent funds
  - **Listed** PE companies seem to benefit from the advantage of a more permanent source of capital
  - In **captive** PE companies, the managers are acting as employees of the parent bank, insurance company, or corporate (or, occasionally, government) rather than principals in their own business
  - **Semi-captives** too may raise independent funds to supplement the monies allocated by their parent
  - **Independent** PE funds are the most traditional method of raising money through banks, pension funds, insurance companies, large corporates, governments, and wealthy individuals
- A PE company will raise a series of such funds, which will have a limited life
- Independents are often structured as limited partnerships, with the PE company as the general partner and the investors as limited partners
  - The PE company will take a management fee, as a percentage of the monies raised (often 1–2%), and will also get a carried interest (e.g. 20% of any profits the fund makes in excess of 8% per year)

Private Equity Deals



Due Diligence

- PE companies take due diligence very, very seriously and commit far more time and resource to it than do commercial buyers. They will investigate both the **business** and the **management** team
- Due diligence shows that the management team is capable of undertaking the transaction and successfully running the business
  - If there is one (or more) weak member(s), the PE company may demand that a manager be replaced
- The management team should also do **due diligence on the providers of capital**
  - How good are they as investors? Are they supportive of their investments?
  - Do they take board positions in their investee companies, or do they manage in a more hands-off way?
  - Do you like these people, and are you prepared to be tied to them for many years?

Types of Private Equity Transactions

Management buyout (MBO)	In this transaction, the company's current operating management acquire the business, or purchase a significant shareholding in it.
Management buyin (MBI)	A buyin is similar to a buyout, expect that the management team comes from outside the company. Sometimes they have worked together previously in another company, but often the management team is put together by the PE investor.
Management buyin/buyout (BIMBO)	A BIMBO is a transaction in which some members of the management team acquiring the company come from its existing management, and some of them are outsiders. Quite often the new CEO will be an outsider, but will retain some of the company's existing management team, who will also become equity investors.
Institutional buyout (IBO)	In an IBO, a PE firm buys the company, following which the incumbent and/or incoming management will be given the chance to buy a stake in the business. The deal is driven by the institution(s) rather than the management. Such deals may be quicker to do, because the equity provider is negotiating directly with the vendor, rather than also with the management.
Leveraged build-up (LBU)	Here, a PE firm acts as principal to buy a company with the intention of developing it into a larger group by making further acquisitions in a specific business area. This is also known as 'buy and build'.
Public-to-Private (P-to-P)	The term refers to buying a listed company and taking it off the stock market. This transaction could be any of the above.

Selecting Financiers

- Once a PE company is on board for the deal, they will help to make introductions to other sources of finance, including bank and **mezzanine** lenders, and other PE companies with whom they might want to **syndicate** the deal

- An advantage of syndicated (‘club’) deals is that they share the risk and also enable larger targets to be acquired than one PE company could afford on its own

- Sometimes, bank finance can be arranged as part of the purchase, using ‘**stapled financing**’
  - Here, the lead bank advising the vendor will guarantee to offer debt finance to the successful bidder, up to a certain amount

Deal Structures – What Funding is Needed?

- The funding to be raised will primarily comprise the purchase **consideration** for the business, to be paid to the outgoing shareholders

- Funding will also be needed to **develop the business**
  - PE does not normally invest in businesses unless they anticipate growth – and that growth will almost certainly require additional funding

- Financial forecasts should demonstrate how much of that funding can be **released** from internal sources (e.g. by better management of working capital) and how much will need to be funded externally

- Finally, **professional advisors**, such as accountants, lawyers, and other professionals will need to be paid, as will arrangement fees to financiers

Deal Structures – What Can the Business Afford?

- Debt finance involves **regular interest payments** and a **repayment** schedule
- Evaluation of the company's debt capacity via various forms of **interest coverage**:
  - EBIT / interest charges
  - EBITDA (or EBITDA less maintenance capex) / (net) debt
  - **Cash interest** (or cash interest plus cash debt servicing) **coverage**, et al …
- Lenders will also be interested in the **level of security** for their debt and the ability to make repayments of principal
  - **Also consider easily separable assets** – for example, retailers where the property can be sold and the leased back, with the proceeds being used to pay down debt

BuyOut Ltd is forecasting operating profits of £140,000 in its first year of operation. The directors and the providers of finance have agreed that interest cover of 3.5 times is adequate for safety. Interest rates are 7%.

BuyOut has operating profits of £140,000

Therefore, with interest cover of 3.5 times, it can afford to pay an interest charge of £40,000.

With interest rates of 7%, this represents a capital sum borrowed of £571,400.

Relating the Debt / EBIT ratio to interest cover

G = D/EBIT, therefore EBIT = D/G
Interest = Di
Interest cover = EBIT/Di = (D/G) ÷ Di
Which simplifies to 1/Gi

- Interest cover is the inverse of Debt/EBIT multiplied by the interest rate

- Often, rather than Debt/EBIT, Debt/EBITDA is applied
- EBITDA better represents the underlying cash flow
- However, amid minimum reinvesting the depreciation using EBITDA less maintenance capital expenditure may be a better indicator

For example, in a transaction with a Debt/EBIT multiple of 5 times[3], where interest rates are 10%, the interest cover will be $1/(5 \times 0.1) = 2$ times. This would not be appropriate for an organization with high business risk and a need to conserve cash.

Deal Structures – What Do the Parties Want?

- Selected **stakeholders agendas**:
  - Management generally undertake an MBO in order to become their own bosses and to get rich through an ultimate exit
  - The PE companies are taking a risk in making this illiquid investment, and are doing so in order to make a good return
  - Lenders have to be able to protect their downside

- **Relationships** between these parties are **complex**, and constantly changing during the acquisition process:
  - In negotiating the purchase price of the business, the vendor is pitched against the combined might of the management team, the equity investors and the banks
  - In negotiating the banking terms, the PE firm and management team are up against the banks
  - In negotiating the equity split, the PE investors are now on the opposite side to the management team
  - Individual members of the management team may each be defending their own corner when it comes to negotiating equity terms and employment contracts

Structuring the Deal

- Determine **how much** finance is needed
  - This should be the total finance, sufficient to cover the deal price, working capital requirements, future cash requirements, and deal fees

- Ascertain how much of that finance can be taken as **debt**
  - Debt is a cheaper form of finance than equity, and the gearing of the deal will affect the equity returns
  - The level of debt will depend on the asset backing of the business, and the amount and quality of its cash flow generation

- Determine how much funding the **management** will be able to put in
  - Investors will generally expect this to be at least 1 year's salary, often more

- Knowing the total funding needed, the level of debt, and management's contribution, with the balancing figure to be supplied by the PE institutions
  - This will be split between ordinary and preference shares
  - Factors to consider here are the percentage of equity that management will have in the business, and the prospective IRR on the institutional investment, payment terms, the dividend on ordinary shares, etc

Financing Structure for an MBO: Initial Parameters

The management team of MaMBO is putting together an MBO from Parent, their holding company

- They have approached a PE company, PE-Co, which has agreed to lead the deal
- PE-Co has discussed the deal with BestBank, which is leading the debt

- Purchase price £10 million to be paid to Parent
- Further £2 million required to fund working capital and deal costs
- MaMBO expected to make operating profit of £1.5 million in the first year post-deal

- BestBank has stated that it will lend at 8%
- Coverage covenant that interest cover will not fall below 3 times for the first year
- Gearing covenant, that debt will never exceed 50% of total funding

- The management team between them are investing £200,000

Debt Capacity in an MBO

The bank funding is firstly limited by the interest cover covenant:

Forecast operating profit	£1.5 million
Interest cover (min)	3 times
Therefore, maximum interest charge	£500 k
At 8%, this equates to borrowing of	£6.25 million

However, the gearing covenant will supersede this, as debt can not exceed 50% of total funding (of £12 million).

This equates to a borrowing of	£6 million

Structuring the MBO Using Differential Pricing

Investment by management	£ 200,000 (3.3%)
Investment by institutions	£5,800,000 (96.7%)

	Investment	No. of shares
Management at £1	£200,000	200,000
Institutions at £7.25	£5,800,000	800,000
	£6,000,000	1,000,000

Management now owns 20% of the company's equity, which they would probably see as a worthwhile investment for their trouble.

	Investment	No. of shares
Equity		
Management at £1	£200,000	200,000
Institutions at £1	£800,000	800,000
	£1,000,000	1,000,000
Preference shares		
Institutions	£5,000,000	
	£6,000,000	

Rewards on Exit

	Initial deal	Exit
Finance required	£12,000,000	
Sales proceeds		£15,000,000
Less debt	6,000,000	4,000,000
Management and institutions	6,000,000	11,000,000
Less preference capital	5,000,000	5,000,000
Equity funding/return	£1,000,000	£6,000,000
Equity investment/return		
Management (20%)	£200,000	£1,200,000
Institutions (80%)	£800,000	£4,800,000

Illustration of Envy Ratio

- For the MaMBO buyout the institutions put in a total of £5.8 million for ordinary
- and preference shares, …
- … and ended up with 80% of the equity

- Management put in £200,000 …
- … and ended up with 20% of the equity

From the institutions' point of view	5.8 million/80%	=	7.25 million	(A)
From management's point of view	0.2 million/20%	=	1.0 million	(B)
Envy ratio (A/B)			7.25 times	

Institutional Return

- One way to meet management's desire for a higher percentage of the equity …
- … is for the institutions to increase their potential IRR …
- … by taking a dividend return as well as a capital gain on exit

- Assume in the MAMBO LBO the preference shares carry a dividend of 7%, payable at the end of each year

	Year 0 £million	Year 1 £million	Year 2 £million
Investment:			
Preference shares	(5,000)		
Ordinary shares	(800)		
Preference dividend		350	350
Capital repayment			
Preference shares			5,000
Ordinary shares			4,800
Annual cash flow	(5,800)	350	10,150

IRR = 35%

Ratchets

- There are times when management and the institutions cannot agree about the future prospects of the business
  - Management want a high percentage of equity, believing that the company will do incredibly well
  - However, the institutions might argue that there is no guarantee that the company's performance will improve, and so they need a high equity stake to ensure their return

- A ratchet can be the answer
  - A ratchet is a device that enables the **proportion of equity held by management to be altered depending on what profits the company achieves** (or depending on any other variable specified)
  - A ***positive*** *ratchet* starts management at a low equity percentage with the incentive that should they perform well their percentage will be increased
  - A ***negative*** *ratchet* starts them at a high equity percentage, but they will have to forfeit some shares if the company does not meet its targets

- However, frequently ratchets only solve the immediate problem
  - In many cases they lead to even greater problems in the future when the ratchet is (or is not) triggered …

Improving Returns with More Leverage

- In a leveraged recapitalization the cash flow that the company has generated during its PE ownership is used to pay a **large dividend to the owners**, and more debt is taken on to refinance the company
- This often happens very quickly, with cash being generated by selling off unwanted assets
- The early dividend payment will greatly improve the PE company's IRR; indeed, it can mean that the whole investment is repaid after a relatively short period, and the PE company still retains a substantial percentage of a profitable business

Leveraged Deals - Hertz

Hertz, the car rental company, was a buyout from Ford in December 2005

- Total deal size about $15 billion
  - $4.4 billion paid to Ford for the equity
  - $0.4 billion of fees and expenses
  - Over $10 billion of the company's debt
- The PE firms put in some $2.3 billion, with the balance of the purchase price being financed by various tranches of debt
- Some 6 months after the deal was done, the company borrowed $1 billion, …
- … which was then paid to the investors as a dividend, …
- … meaning that they had recouped nearly half of their investment
- The resultant high gearing was reduced in an IPO in November 2006
  - This left the PE companies as major shareholders, but having considerably reduced their investment
- This transaction appears to represent gains made purely from financial engineering, rather than from any significant improvement in the underlying business

Leveraged Deals – Hertz (cont´d)

Was Hertz better off in May 2013 than it was seven years before?

- Hertz's private equity sponsors sold their remaining shares in May 2013, …
- … fully existing the company more than 7 years after buying it from Ford Motor Co
  - That deal came in the midst of private equity's "golden age," and was one of that era's most-criticized transactions
  - Not so much the original purchase, but rather the subsequent US$1bn dividend recap and IPO -- both of which were completed less than one year after the original buyout

- Hertz went public at US$15 per share in November 2006 …
- … and opened trading on 9 May 2013 at US$25.75 per share
  - That's a 71.67% gain, compared to a 16.42% gain in the S&P 500 over the same period.
  - Hertz shares had sunk as low as US$1.55 per share during the 2008 financial crisis -- but long-term investors who bought at IPO have been rewarded.

- Hertz was valued at approx US$15bn (including debt) when acquired by The Carlyle Group, Clayton Dubilier & Rice and Merrill Lynch Private Equity
- Enterprise value on 9 May 2013 was in excess of US$25.5bn

Leveraged Deals – Hertz (cont´d)

Was Hertz better off in May 2013 than it was seven years before?

For the Fiscal Period Ending	12 months Dec-31-2005A	12 months Dec-31-2012A
Currency	*USD*	*USD*
Total Revenue	**7,469.2**	**9,020.8**
Growth Over Prior Year	*11.9%*	*8.7%*
Gross Profit	**1,680.2**	**2,179.3**
Margin %	*22.5%*	*24.2%*
EBITDA	**1,232.4**	**1,445.0**
Margin %	*16.5%*	*16.0%*
EBIT	**1,041.7**	**1,188.3**
Margin %	*13.9%*	*13.2%*
Earnings from Cont. Ops.	**362.6**	**243.1**
Margin %	*4.9%*	*2.7%*
Net Income	**350.0**	**243.1**
Margin %	*4.7%*	*2.7%*

Source: CapitalIQ

Notes: (1) The original buyout closed on 12/20/05, so 2005 data includes 11 days of results under private equity ownership. (2) Hertz completed $2.3 billion purchase of Dollar Thrifty on 11/20/2012, so 2012 data includes 41 days of combined financials.

Leveraged Deals – Hertz (cont´d)

Was Hertz better off in May 2013 than it was seven years before?

- All of the **top-line numbers** - except for net income - are **better** in 2013 than before private equity got involved …
  - … perhaps due to big corporate **acquisitions** like Dollar-Thrifty and strategic moves like adding around 1,000 new off-airport locations

- Hertz also had over US$15 billion in **debt** at year-end 2012, or **about 50% more than** it had **at** the time of its original **buyout**

The biggest winners in the Hertz buyout were the private equity firms

- Generated around US$3.7bn in investment profits from original US$2.3bn investment …
  - 2.6x cash-on-cash return
  - Around 30% gross internal rate-of-return

- … however, not at the expense of the company - as many originally feared: Instead, it seems to have been a „win-win“ …

An Alternative View of Private Equity

- Excessive use of debt
  - Making returns by gearing up the investee companies…
  - … with very high gearing often associated with company failure

- Societal impact of restructuring
  - Restructure as making a lot of the workforce redundant

- Impact on the capital markets
  - … when management takes a company private and then re-floats it a few years later at a higher value …

Summary

- PE is the investment of equity outside a public stock market, in larger transactions
- PE companies can raise their money from the stock markets
  - … whereby it is more common to raise independent funds, or "captives" of financial institutions
- PE requires supporting infrastructure, such as experienced bankers, financiers, and professionals. In addition, the legal and regulatory systems must be strong enough to reduce the perceived risk of investors
- PE transactions include MBO and buy-ins, plus various other forms of deal where the ownership of a company changes hands. Often they involve a listed company becoming privately owned
- PE transactions are usually highly geared
  - Investors make their returns from this gearing, and also from taking a close interest in managing the businesses, and a reduction in agency costs
  - In addition the PE investment itself will be geared up in order to increase management's relative stake in the business by using preference shares as part of the financing structure
- Advantages claimed for PE investors include a reduction of agency costs due to the closeness of the investor to the management and operations of the company

Appendix

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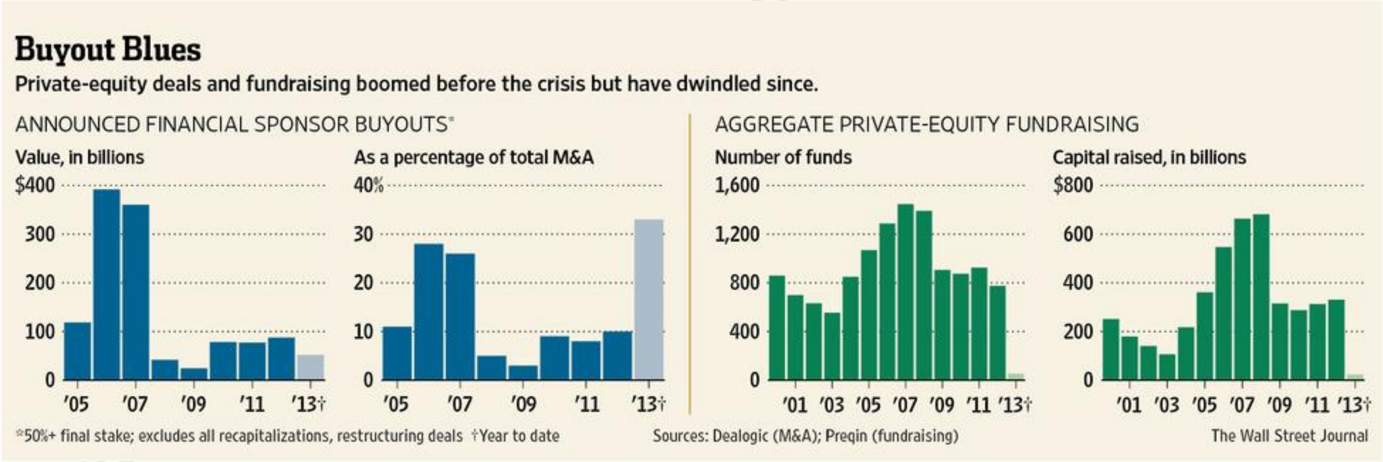
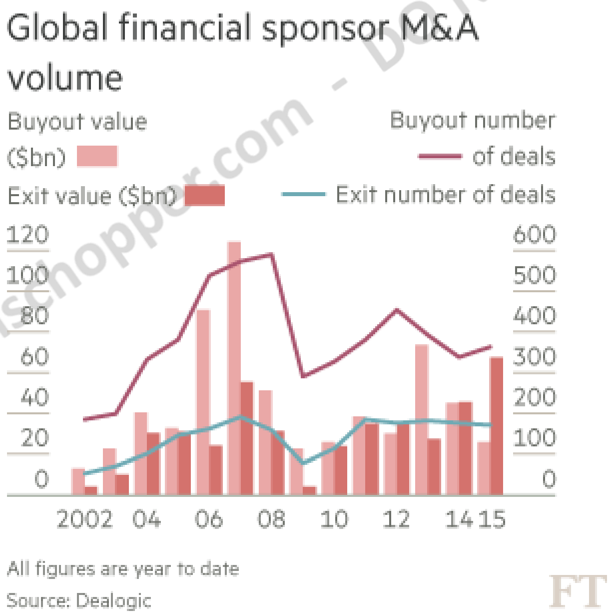
Private Equity – Capital Raising and Deal Activity



Private Equity – Deal Activity



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