

MANAGING THE BUYOUT PROCESS ROUNDTABLE



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Facing high valuations, growing competition for assets and mounting pressure from limited partners to enhance returns, successful management of the buyout process has become a fundamental factor for private equity houses looking to deliver the expected value identified in an investment. This roundtable covers the challenges and risk associated with the buyout process and explains the strategies used to mitigate or overcome the hurdles. ►►

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Mr Bonfield joined Calyon in December 2005 as Head of European Financial Sponsor Coverage. He has spent the past 17 years on the banking side of the private equity market, initially at Natwest, followed by seven years at SocGen (where he was Global Head of Acquisition Finance) and more recently four years at Scotiabank Europe (where he was Head of the Private Equity Sponsor Group).



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Mr Cochran's core practice includes the representation of both financial and strategic purchasers in merger and acquisition transactions. While resident in London, he was involved in a number of cross-border deals involving US multinationals. Mr Cochran also has significant experience in buying and selling distressed companies.



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Since joining TPG in 2003, Mr Costeletos has led the \$3bn take private of Debenhams, a leading department store chain in the UK and, recently, the \$2bn buyout of TIM Hellas and Q Telecom, two wireless telecom operators in Greece, representing the first significant buyout in the country. He previously worked with Investcorp, JP Morgan Capital and Morgan Stanley in London and New York.



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In your experience, what major differences are evident in the way buyout houses are approaching their transactions today, compared to 5 or 10 years ago?

Penn: Clearly, the buyout industry itself has grown and the size of funds has grown significantly. Ten years ago there were only a handful of billion-dollar shops, but that number has soared. Both limited partners and investors believe the size of transactions executed by these funds will continue to grow. \$1-5bn deals are relatively common, \$10bn deals are more frequent and we are rapidly approaching the \$20bn mark. Favourable interest rates have allowed for an increase in debt capacity, which has also fuelled the size of the transactions.

Bonfield: Taking the 10 year horizon first, the approach has opened up considerably with public-to-privates, management buy-ins and secondary buyouts now standard fare, in addition to the opportunities to re-capitalise investments in sometimes astonishingly short time-frames. To me, the greatest change in more recent times has been the much smarter use of liquidity across all debt markets to achieve optimal financing structures and indeed to de-risk, from an equity investment perspective, very rapidly through recapitalisations. The establishment within certain equity houses of teams that focus principally on arranging funding has been a key driver here.

Cochran: One of the biggest changes reflects the outlook on exit strategies. Reduced liquidity for smaller companies in the US capital markets has required buyout firms to focus on investing with longer holding periods. Multiple arbitrage strategies through the public equity markets are no longer as viable as they may have been in the late 1990s. Buyout firms also tend to focus on operational issues and internal growth objectives leading them to either partner with operators or have principals with operating experience. With the increase in both the size of funds and the number of funds, differentiable investment strategies are critical. It is difficult to be just another middle market private equity fund focused on manufacturing and distribution businesses. Markets approaches have been refined to cut across industry verticals and sub-verticals.

Perry: There are very few, if any, off-market transactions of a significant size today. The private equity business model has matured over the last 5-10 years and now there is much more effort going into understanding where value can be created post acquisition. Buyout houses are spending an increasing amount of time with their investments post acquisition working in partnership with management to develop the business. What happens in the first 100 days post acquisition is key to delivering the targeted returns.

Costeletos: The most successful private equity firms have continued to evolve their due diligence and investment decision-making processes.

Gumina: What is critical for all buyout funds, relative to where we were five or ten years ago, is the ability to add value from an operating perspective post closing. Given how competitive the market is and how sophisticated the sellers are, buyout firms have to assume that they are paying a full and fair price for investments and that nothing is being purchased at a 'discount'. Success is

often dependent on what the buyout firm can bring to the table post-closing. For example, many firms have operating partners whose expertise they can draw on in certain situations to improve acquired companies. Also, the 100-day plan is not just consulting jargon anymore. Having a thoughtful operating plan, whether it's a 100-day plan or a 300-day plan, is critical. You also need a process to manage, oversee and measure that plan through the first year of the investment.

In this market, it is vital for a private equity firm to have a differentiating factor to win transactions. Whether you are the best in a particular sector, the best in a particular product class or the best in a particular structure, the buyout house needs to communicate this differentiator to a seller, to convince them that they are the best partner in the long run. It is also important to have tight internal processes. Since there are often multiple potential buyers talking to the seller, an emphasis needs to be placed on making quick decisions, running an efficient process, managing information and communicating regularly with the target company.

What methods are private equity firms using to generate deal flow? How have these deal origination strategies altered in recent years?

Perry: Deal flow is probably one of the biggest challenges for all the buyout houses – particularly as we are seeing very large funds with plenty of capital being raised. Accessing the right transactions is a real challenge for these funds. They tend to use a variety of different routes to market. Some rely on their recognisable brand, others turn to their network of advisers – accountants, lawyers and investment banks – who now see private equity houses as a very significant revenue stream. There are multiple origination strategies focused on identifying the right transactions. Of course, there are also auction processes – particularly in Europe where they are far more common now than they were five or 10 years ago. Most large transactions go through an auction, and as private equity houses look for more effective ways to put their capital to work, the size of transactions they will contemplate continues to increase.

Cochran: One of the principal objectives of private equity firms is to identify 'proprietary deal flow' that allows them to avoid the auction process. Proprietary deal flow sometimes comes through institutional relationships that the equity sponsor has with its affiliates, including its financial sponsor (such as an investment or commercial bank), its advisor group or its limited partners. Private equity firms also attempt to partner with management teams to explore industry strategies. The common belief is that these management teams have existing relationships with potential targets that have yet to retain investment bankers. Private equity firms often pay finders fees and provide other compensation for deal origination that leads to invested capital. One firm in Miami has even gone as far as offering to provide a high-end automobile lease as an incentive for closed investments. Within the crowded market place, finding unique deal flow is the key to avoiding the auction process.

Bonfield: Proprietary deals are the holy grail, and the best means of finding these are research, networking and a strong market standing. More generally, it is obvious now that most houses have adopted a sector focused approach which allows in depth knowledge of specific industries to be obtained. There are numerous ►►

examples of situations where such clear expertise has borne fruit. The development of panels of operating partners and the engagement of proven business leaders in an advisory capacity play an important part in the process.

Costeletos: Most firms continue to rely heavily on opportunities generated by the competitive sale process. Few firms have consistently succeeded in generating proprietary opportunities.

Gumina: Both the rolodex method – where you rely on the individual contacts of the buyout partners – and the investment banking method – where you rely primarily on inbound calls from an investment bank offering an auction opportunity – have worked successfully for different firms in the past. But what many buyout houses are starting to do now is take a more aggressive and creative approach to marketing. Not only are they calling their rolodex list and investment banking contacts, they are also calling accountants, lawyers and boutique M&A firms to build a credible reputation within the market place that will put them first on the list of potential buyers when a seller comes to market. A systematised marketing program that becomes part of the culture of the firm is critical. If the culture is geared towards generating deal flow, speaking proactively to the market and creating inbound opportunities, then the organisation will have a significant number of transactions to review and be able to pick from the best ones.

Penn: A lot of larger transactions are auctioned but some of the smarter shops are starting to execute strategies that allow for large, non-auction deals, such as working with corporations to divest divisions.

When identifying targets, what business fundamentals are most desirable?

Bonfield: Growth prospects, strong market positioning and cash flow generation, as ever. Given recent price movements, the ability to pass through increases in energy and raw material costs is important too.

Penn: One of the key factors is ensuring that the target company has the cash flow necessary to grow and meet the debt payments associated with leverage. Buyers will look for a history of steady, sustainable cash flow and solid margins, preferably in industries that are growing or changing in a way that allows financial buyers to extract value. Good management and excellent future prospects are critical as well.

Gumina: When identifying targets, industry focus is critical. Sector focus allows the buyout house to be quick and responsive when reviewing an opportunity and to be the first to move on a transaction. Some key fundamentals that apply regardless of sector are strong cash flows, identifiable growth opportunities, good market dynamics and either a solid management team in place or the ability to attract the right management talent.

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BUDDY GUMINA

Costeletos: An important part of understanding a company's business fundamentals forms a core part of the due diligence process. It is important to identify and build conviction on an investment thesis with differentiated value as the base.

Cochran: This depends significantly on the industry, size and markets of the potential target. Nevertheless, a company's ability to generate free cash flow remains the bedrock of fundamental financial analysis. From a management standpoint, financial investors need to believe that there is both a strong senior management and second tier management team in place. Certain financial investors ignore to their peril issues involving the target company's business culture. For example, in a corporate spin-out, the existing financial team may never have dealt with the critical issues imposed on a business by the use of leverage. Leverage changes all aspects of the cash cycle and can re-define customer and vendor relationships. Failure to focus on culture can lead to early trouble.

Perry: Solid, reliable cash flow is extremely important, along with a strong management team or the ability to put a strong management team in place. A balance sheet that can be leveraged is helpful. A recognisable and sensible market position is important. Reasonable but not excessive capital expenditure requirements are preferred. In a number of transactions, the potential for cost reductions is a feature, but rarely is this the *raison d'être*, although the potential for improving operating fundamentals is a basic need.

What bearing can a detailed historical and economic analysis have on a transaction?

Gumina: Historical and economic analysis depends to an extent on the sector, and it may be more or less significant compared to other issues. For example, in technology and certain areas of healthcare, an economic analysis is important relative to government budget constraints. But regulatory issues and competitive threats, especially in sectors like pharmaceuticals, are ►

as critical as the economic analysis. A potential buyer needs to dig into the weeds and focus on the core issues for a particular business or sector, including economic analysis, but it is equally important not to lose sight of the big issues.

Costeletos: A detailed historical and economic analysis forms an important part of any due diligence process.

Bonfield: It should be an important element of any due diligence process, but it seems that, in some instances in today's competitive market, carrying out detailed historical analysis can hold a buyer back!

Perry: Some buyers are keen to have a detailed historical and economic analysis, while other houses are less worried about it. This analysis remains a classic method of trying to get a good understanding of the target business, although some firms are concerned that understanding the history of the business actually tells you nothing about its future. The difference compared to 5-10 years ago is the greater focus now on how the business will perform going forward and understanding the fundamentals within the current business rather than the historical patterns.

Penn: Detailed and accurate information and analysis allows purchaser to make a good assessment of how much equity and debt they can apply to a purchase price as well as the likelihood of growth through acquisition, geographic expansion or technology development within the target company. Understanding the base business and its historic activity allows buyers to project what is likely to happen in the future, and therefore come up with an appropriate value.

How are financial sponsors valuing synergies in their targets and what impact can this have on their approach?

Cochran: In the current deal environment, companies are trading at fairly aggressive multiples of cash flow. To make these

multiples work, the winning financial bidder necessarily must have an aggressive view of synergies, cost improvements, margin enhancement and growth initiatives. If no value can be placed on synergies in a transaction, then the other elements must be particularly meaningful if the financial sponsor is to value the business.

Costeletos: In situations where the private equity firm is looking for investment opportunities through an existing portfolio company, synergies become an important part of the value consideration. We have been involved in deals where significant synergies were in place that allowed us to bid a higher price than other potential buyers. Clearly, when acquisitions are being made in the same sector as an existing portfolio company, the synergies will form part of the investment plan.

Gumina: It is frequently stated that a private equity buyer does not pay for synergies. But in reality, it is all part of the deal structure and all part of the price. Certainly, slam dunk synergies that can be realised immediately, as part of the 100-day plan, need to be factored into the overall return model. If theoretically the buyout house will be able to use synergies to generate a better growth profile or stronger top line or cash flow growth, it should be prepared to pay for those benefits since they may lead to a superior IRR for the transaction. Moreover, in today's competitive market place, there will certainly be someone in a process who is prepared to pay for those synergies. That's not to say that the presence of competition should affect your deal discipline or that synergies alone should define whether or not you do a deal. Rather, if a buyer is going to expend significant resources and energy pursuing a transaction, it makes sense to focus on transactions involving the best companies that best fit its investment strategy and then to be prepared to 'play to win', including giving credit for some synergies.

Perry: There is far more emphasis today than there was five or 10 years ago on where value is and how value can be created. In an auction, the classic challenge is to pay enough to win the auction but as little as you can to maximise your return. Buyout houses are therefore very interested in how they can create value, and one of the ways to do this is through synergies. When valuing synergies, the buyer will make estimates based on how the performance metrics can change and how this may translate into value on exit. The focus on the impact of synergies enables buyout firms to pay more.

Penn: Projecting revenues, cash flow, value and synergies is a difficult undertaking. Oftentimes financial sponsors are unwilling to include synergies in a purchase price unless they are confident that these synergies have a real economic and value basis over their investment and liquidation periods. Among the ways to value synergies are a break up analysis, a product line analysis and a service line analysis.

Bonfield: I don't see any change here. If buyout houses can pay ►

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SIMON PERRY

a price that ignores synergies they will, but if not, the synergies become in effect a pricing tool.

How have due diligence processes changed over the years? What factors have contributed to these changes?

Costeletos: Most successful firms are likely to have developed greater consistency and discipline, and a more robust methodology, in their due diligence process. This has been driven by the evolution of firms' investment decision-making process.

Penn: In order to see the growth of an investment, both on the venture capital and leveraged buyout side, due diligence has become much more detailed and thorough. Service providers are being brought in to conduct product investigation, detailed legal due diligence, audit and accounting due diligence, revenue recognition, management due diligence, litigation analysis, as well as other key financial and operational aspects of the target company.

Perry: Today, buyers pay more attention to the particular matters that have a significant impact on the success of the business and are relevant to the particular transaction. Ten years ago there was a tendency to run a basic A to Z review of the business, whereas today the focus is on what matters. What are the key issues? What insights does one need to understand the market so one can make appropriate judgements? Due diligence not just as a matter of financial due diligence – advisers now look at the market place, the operating models of the business, environmental issues, IT and so on. These areas are all key to determine what might destroy value and what opportunities are available to enhance value.

Along with the auction process has come vendor due diligence. Looking back ten years, there was very little vendor due diligence carried out, whereas now it is common. That has affected both the timing of due diligence work and the way transactions are executed.

Bonfield: I don't see any change in the depth of diligence undertaken and would be seriously concerned if there had been. The means of delivery has been adapted, though, with much more being vendor-initiated.

Gumina: Diligence processes have definitely changed over the last few years. The third party advisers associated with diligence – the lawyers, accountants and consultants – have been involved with so many private equity transactions that they understand how the process works. They are responsive, able to get to core issues quickly and understand the time pressures that come into play when trying to complete transactions. Also, by focusing on certain industry sectors, private equity players can identify the best advisers within those sectors. To this point, it is important to work with third party advisers that have strong industry knowledge because they will be able to move quickly and efficiently through the process and help the buyout fund reach an informed investment decision.

The auction process often emphasises speed to closure and cuts off the ability for buyers to conduct fulsome reviews. Some deals get done without extensive diligence efforts, which thereby increases the risk for negative surprises post-closing.

MICHAEL J. COCHRAN

Cochran: SOX compliance has directly impacted the importance of financial control and internal reporting due diligence. Buyers continue to stress integrity of cash flows and asset valuations. The auction process, however, often emphasises speed to closure and cuts off the ability for buyers to conduct fulsome reviews. Some deals get done without extensive diligence efforts, which thereby increases the risk for negative surprises post-closing.

Has the rise of auctions dramatically affected the way buyout houses reach a decision on the inherent value of a target and execute their buyouts?

Gumina: Auctions have clearly escalated in the last few years. Sellers are sophisticated and increasingly using advisers in the process. Buyers have to assume there will be competition in any transaction. To this point, perhaps more so than in the past, buyers need to have a very streamlined process of thoughtfully reviewing an opportunity in an efficient time frame. Also, industry sector focus has become even more critical as a result of the increase in auctions in that sector focus enables buyers to identify and respond quickly to the best deals in their target markets. Fundamentally, however, the underlying cash flows, growth prospects and market dynamics of an opportunity still are the inherent drivers of value.

Penn: Since investment periods are four to five years in these billion dollar buyout funds, private equity houses have to aggressively form relationships with investment banks that are executing auctions, in order to have a chance of being competitive when deploying those funds. Although many say they try to avoid auctions, auctions are a source of deal flow vetted by another financial institution, and most large scale companies that are selling assets have to demonstrate the ability to execute an auction. Price is also an obvious factor, along with the ability to explain the financial sponsors' strategy and close.

Perry: Over the last two or three years, private equity houses have played a significant role in many auctions. When corporate ►►

buyers are involved, the competitive bidding structure is altered since a corporate buyer can identify underlying value through adding the target to its complementary existing business. In order for a bidding private equity firm to win the auction and deliver returns, there is a compelling need to find where all the value opportunities lie.

Bonfield: With the level of competition around nowadays, success is often driven by finding an ‘edge’. Without an edge most houses will stand aside from the auction. Value is achieved at exit and so any entry valuations will be viewed in the light of likely exit scenarios – the most challenging question now in my view is whether excessive liquidity in the debt markets will still be inflating purchase multiples in two or three years’ time.

Cochran: Auctions, in theory, create more efficient sale processes and therefore result in higher valuations. Financial investors must adopt their techniques to participate. Speed to closure is also of paramount importance.

Costeletos: Ultimately, an investor’s ability and willingness to pay a higher price is likely to come from its ability to identify differential value, and their conviction in the business plan.

From a legal perspective, what indispensable factors must be considered when structuring deals if they are to prove successful?

Perry: The legal fundamentals of transactions has not changed significantly over the years. The appropriate legal contract for any acquisition is a function of the buyer, the seller and the circumstances of the business. The contract is intended to identify the issues that are relevant to the transaction including the purchase price, and also to give clarity as to whether the buyer is receiving what it expects. Warranties, indemnities and the structure of the contract are designed to test the seller – to determine the certainty of what is being sold. The idea behind a contract is not necessarily

that the buyer will call on it later to obtain some kind of restitution, but that the buyer has identified in the contract process all the issues that they need to understand about the business they are acquiring.

When you buy a company you buy its history. Particularly from a legal and tax perspective it is very important for a buyer to understand the legacies it is inheriting and to make sure that it can operate freely in all anticipated circumstances. This is particularly relevant for companies with intellectual property. A buyer also needs to understand the relevant tax liabilities in any jurisdictions in which the target operates – especially if the company operates in emerging countries where the regulatory and legal environment is not so clear.

Gumina: Buyers spend a lot of time going back and forth to hash out a legal contract and all the ancillary documents. But at the end of the day, it is absolutely vital first and foremost to pick the right company and the right management team. However, there are a couple of indispensable aspects within the actual legal structure. For example, if the sellers are to receive a significant liquidity event at the time of sale but retain an ownership stake going forward, the buyer will often structure their investment on a preferred basis relative to ownership retained by a seller. The right to make appropriate decisions regarding the direction and strategy of the business is a critical component of any transaction, whether it be a majority buyout or a minority investment. Generally, a legal document simply structures the way in which parties come to the table to discuss, plan and negotiate issues relevant to the business.

Penn: Financial sponsors need to structure in the appropriate triggers to manage downside, to manage the performance of the company, and to manage the economic power and control of their securities. Indemnities, representations and warranties are critical in these transactions and failure to structure them properly can often come back to haunt buyers in the future. How the purchase price will be paid over time and the fees associated with the equity are also important.

With the level of competition around nowadays, success is often driven by finding an ‘edge’. Without an edge most houses will stand aside from the auction.

Cochran: Any transaction involving multiple purchasers (such as club deals) requires extensive legal work in the resolution of corporate governance issues as well as investment issues. Upfront dispute resolution mechanisms and divorce procedures critically impact long-term success. Inter-creditor issues also involve significant legal structuring in complex capital structures. The use of seller paper, seller notes and earn-outs require particular care, particularly if the seller remains in management following a leveraged recapitalisation transaction. Misaligning interests leads to difficult early deal tensions between management and financial sponsors.

How important has it become to partner with and incentivise existing management teams?

Cochran: For financial investors, management success is one of the key drivers of solid returns. Management teams must be ►►

ROB BONFIELD

compensated for delivering superior returns to their equity sponsor.

Bonfield: Arguably less so, if one views the question in the context of the prevalence of buy-in managers in completed deals. That said, there is huge value in working with quality managers who possess an in-depth knowledge of their business from within. Incentivisation is the bedrock of the industry.

Penn: It is important for buyout professionals to partner with management teams that understand the private equity process and have a clear view to exit. They should also have experience in their given industry and an entrepreneurial spirit. In many large companies, executives can find it difficult to go from a more hierarchical system in running a company, to a free standing company with financial sponsors, so the buyer has to find a management team that can successfully make that transition.

Perry: Partnering with a good management team and putting up appropriate incentivisation is fundamental to a successful transaction. Many buyers, if unable to resolve this issue, will simply not progress with the transaction. The buyer has to know how it is going to operate the business and how it is going to extract value on a day to day basis. The management team is crucial in this regard and they need to be incentivised to make the process work. One of the strengths of the private equity model is the ability to incentivise people, both through regular pay and with rewards relative to the increasing value of the business over time. Arguably, buyout houses have a considerable advantage to corporate buyers because of the concerns surrounding significant pay packets in the public domain. In the private equity world it is easier to incentivise management financially.

Costeletos: Existing management play a significant role. It is paramount to ensure that the management team backed by the private equity firm has the necessary resources and are incentivised to deliver their plan.

Gumina: Developing the appropriate management incentive program which is in line with the buyout firm's objectives is a critical component of a deal. To this end, the buyer needs to understand the growth and exit strategies for the investment such that the incentive programme matches the overall game plan for the company. If the plan is to execute acquisitions, a component of the incentive plan should be geared as such. If the plan is to pay down debt, then the focus will be on free cash flow. Another important part of a transaction is for management to be a capital investor alongside the private equity firm which means their decisions will be made both as shareholders as well as managers, aligning them with the buyout house. The basic rule is to have a strategy in mind and to develop an incentive programme to match this strategy.

With the vast amount of liquidity in the debt markets spoiling acquirers for choice, what factors need to be taken into account by buyout firms when assessing all the finance options?

While the current debt markets have created the opportunity for innovative financing options, it is important to ensure that the financing structure is consistent with and supports the company's strategy.

PHILIPPE COSTELETOS

Penn: Debt, and the different types of debt, has enabled more these transactions and is more important as deals grow larger. One of the issues we may find going forward is that there is insufficient debt to meet the needs of larger purchase prices. But that is not presently the case.

Perry: There is a much lower cost of debt in the markets today, fundamentally as a result of the western economies successfully managing inflation. Finance has been readily available over the 24 months. Buyout houses need to make sure they obtain the right finance with the appropriate flexibility. Buyers also need to be conscious of the mix of debt products, to ensure the structure reflects the underlying business.

Gumina: The debt markets are hot: they are good for sellers, they are good for completing a dividend recap and there is a significant amount of debt capacity available for acquisitions. In a leveraged buyout, management experience is important. The financial sponsor needs to determine whether management has worked in a leveraged environment in the past, and has experience communicating with creditors and responding to covenants. There should be sufficient depth in the financial team to proactively identify a potential issue two or three quarters down the line, and be able to respond immediately to avoid running afoul of debt providers. While the amount of debt is important, the structure of the debt securities is also a key issue. For example, for growth companies a flexible debt structure, with limited near-term amortization or cash requirements will be important to support the growth plans for the business.

Costeletos: While the current debt markets have created the opportunity for innovative financing options, it is important to ensure that the financing structure is consistent with and supports the company's strategy.

Bonfield: As always, deliverability and long-term dependability are key factors. The second factor is one that is currently being ►

substantially ignored, although admittedly out of necessity in a very competitive market. It does suggest, though, that when the next market correction comes, it could be particularly painful for some.

Cochran: Beyond the economic pricing issues, buyout firms should focus on which lenders will allow the business to grow as well as which lenders will be good to work with if the target does not perform to expectations. Capex, letter of credit and acquisition facilities can provide means for future growth. A lack of insolvency or deep portfolio management experience can accelerate periods of trouble into periods of financial crises.

How important is it for financial acquirers to select the right composition of debt instruments and tranches, and push for the best terms and conditions on their debt?

Bonfield: Some would argue this is very important, but major equity houses have told me less so recently. In any situation, it is important to obtain competitive terms, but I subscribe to the view that squeezing until dry is not necessary, if you can get the deal done another way. It is partly about what needs to be done to meet the bid, but it is also prudent not to overburden businesses and to allow some room to manoeuvre.

Cochran: While the capital structure is important in the overall transaction, the absolute best pricing may not lead to the best financial partner for the future growth of the business. If the buyer is making an acquisition in a historically cyclical business such as the textile or automotive industry, the best lender may be the lender with the most experience in the industry; not the cheapest.

Gumina: The right debt partner is critical. Certainly, everyone tries to develop and negotiate the best deal, regarding terms and conditions. But it is worth noting that if the deal is dependent on having the absolute lowest LIBOR rate in the capital structure, there is probably a fundamental issue with the transaction.

The right debt partner may have sector experience and be

familiar with the ups, downs and challenges associated with a particular industry. They should understand the buyer's game plan such that structural changes post-closing, like increasing a debt tranche to accommodate acquisitions, are expected. In completing transactions, a buyout firm should be highly focused on who is in the capital structure from the beginning and what their transfer rights are. Debt providers should be partners in a transaction and be shoulder to shoulder with the buyout fund throughout the deal.

Perry: It is important to get the debt structure right. The covenant structure will allow the finance providers some level of control over the destiny of the company if it fails to perform as planned. Sufficient attention must be paid to these areas in the transaction process because if the acquisition moves into default on the covenant, this may give the lenders an unwarranted position of influence over the business. The structure of the debt needs to reflect the underlying cash flow performance of the business.

With consortium deals on the rise, do you foresee any problems springing from their ownership and control structures in the future?

Costeletos: We would expect to see more consortia deals in the future. The problems that arise from ownership and control structures depend on the relationship between the sponsors as well as the nature of the investment. When the deal involves a significant turnaround type of investment, for example, it is important to have one or two lead investors take ownership of the opportunity, as opposed to other investments such as traditional buyouts or growth buyouts.

Penn: As long as there is an alignment of interest between the consortium participants and the ownership and control rights are managed to meet each of the participant's needs, problems can be mitigated. Obviously there will always be an issue with who leads the deal, who follows, who teams up and who really has the economic power.

Cochran: All financial investors have different approaches and philosophies to management and growth. They also have different return expectations, investment horizons and risk tolerance. All of these factors lead to difficulties in a five to seven year investment cycle.

Perry: There is a strong incentive to form consortia in order to do bigger deals. But if a buyout house plans to source deals as a consortium, the downside is the firm is not differentiating itself from the other houses, which can undermine the brand. There are also some issues regarding how the investments are managed when they underperform and then governance issues become important. Some of the advantages gained in moving quickly may be lost when the ownership structure is made up of four or five firms. That said, the size of businesses bought by consortia tend to be large and stable. ►►

As long as there is an alignment of interest between the consortium participants and the ownership and control rights are managed to meet each of the participant's needs, problems can be mitigated.

LAWRENCE E. PENN III

Gumina: Consortium deals are definitely on the rise and like any other part of a transaction they need to be managed thoughtfully. It is important to select the right partners for the consortium and to have a clear vision for the future. For example, all the partners should identify the basis for growth in the business, and how management and expansion methods factor in. There may be nuances here and there but the main vision is shared. Also, the partners should understand the teams and the culture of the other private equity firms, as there are opportunities to execute successful consortium transactions alongside partners you know well and with whom you've done business in the past.

Can you describe some of the post-deal value creation methods that are proving popular with buyout firms in today's market?

Perry: Buyers and their advisers spend a lot of time planning for the first 100 days post acquisition. Issues identified during the transaction need to be followed through during this time. Working capital management is a good example. It is crucial to ensure the acquired entity is operating as effectively as it can in all the different parts of its business, in terms of how it collects its receivables, how it turns its inventory, how it pays its creditors. Another area to consider is making sure the business has accurate and reliable financial information about how the performance of the business from day one. Although this may sound basic, many businesses are acquired out of a group and any disruption or change in the reporting structure can require replacement of the prior reporting processes.

Cochran: Outsourcing remains a viable strategy for financial buyers. Often existing management is wedded to certain distribution channels or imbedded assets. The financial buyer should have a fresh opportunity to re-evaluate these channels and assets and optimise them. Growth through acquisition also remains a popular approach.

Bonfield: Exploring a wider range of financing options is becoming increasingly relevant. Within the private equity market, there has been an upswing in the use of property financing structures, securitisation has been around for a while and we are also starting to see more project financing-type structures in evidence. The challenge is to ensure that different structures are applied only in the most relevant situations.

Penn: Executing add-on acquisitions is popular. Product and service line expansion is also prevalent but what is going to be most popular going forward is expanding globally in growing markets that include Western Europe, Eastern Europe, China and India, and in some cases the Middle East.

Costeletos: A superior operational capability is paramount in situations when there is greater investment risk in the deal, such as turnaround situations. It is important to leverage this capability during due diligence as well as post acquisition.

Gumina: Post deal value creation is dependant on entering transactions with a short and long-term game plan. For example, value can be created by bringing in operating partners – either from the buyout house's existing staff or drawn from its network – who have expertise in a particular space or experience handling a

specific company issue. Providing good guidance on finance, marketing, compliance and add-on acquisitions is a great resource to bring to bear for a company. Also, being sector focused enables the private equity firm to develop a deep network and build strong relationships. This network may comprise not only operating partners, but also supplier relationships, customer relationships or other business relationships. A sector focus may also allow the buyout house to leverage synergies within its own portfolio, to generate buying power, for example.

Is it crucial for acquirers to plan for exit and execute their chosen strategy as soon as the deal closes?

Cochran: Every financial buyer is ultimately a seller. Only through the sale, will a financial buyer realise the benefit of the strategy. Therefore, in my experience, all sophisticated financial buyers vet multiple exit strategies prior to closing.

Gumina: Executing the game plan, picking the right management team and picking the right debt partners should theoretically create a good exit or a strong IRR. The buyout house should remain flexible about their exit, considering anything from an IPO to a strategic sale to a financial buyer sale. Exit strategy should be discussed at every board meeting – not necessarily as an action within the next three months, but as part of long-term planning. This ensures that the right steps from a management perspective are being taken to position the company for the most appropriate exit. It could mean looking at the sales force or looking at the customer base. It could mean starting to comply with Sarbanes-Oxley to prepare for a public life in 12 to 18 months. Being thoughtful about exit is critical not only on day one but on every day throughout the life of the investment.

Costeletos: One must make take a view on a viable exit strategy when developing an investment thesis. However, the exit strategy will often include several viable options and ultimately the final exit will be driven by the successful implementation of the business strategy. It is not necessarily the case that as soon as the deal closes, the buyout firm will start executing the exit strategy.

Penn: It is crucial for acquirers to plan for exit before the deal closes. They need to go into every deal, well before they cut their first cheque, asking the question, how do I get out? Most buyout shops understand that this issue is central to executing and managing the structuring process. The buyout house cannot structure the deal without anticipating exit options, including downside and upside scenarios. This affects how the equity and debt is structured, the warrant agreement, the management agreement and risk-sharing agreements.

Perry: Most, if not all, buyout houses consider their exit strategy as part of their original evaluation of target the entity. If a situation arises that allows them to realise that expected value earlier than originally planned, buyers are likely to take that opportunity. A number of companies have been bought and sold fairly quickly for substantial increases in price. Focusing on and planning an exit strategy is entirely appropriate and sensible, whether that involves growing the business over three to five years, making a number of changes, introducing new products, reducing costs in certain areas, entering new markets or accepting an attractive offer much sooner than anticipated. ■