THE NETWORK
OF LEADERS
CRITICALEYE

Private Equity: The Nature of the Beast

Discussion Group

Date: 12 May 2009

Chair

Arthur Stewart, Partner, Simmons and Simmons

This article is based on the proceedings of a meeting of Members of the Criticaleye Community. To encourage open debate, the meeting was held under the Chatham House Rule. This article therefore identifies no names or companies represented at the meeting, but presents the distilled insights and conclusions from the session.

Introduction and summary

Private equity money has backed some of the largest and most audacious M&A deals of the past decade, but now that the flow of credit has slowed to a trickle and covenants are tightening, the days of blockbusting management buy-outs (MBOs) are over. Nevertheless, $23.1 billion was raised by UK funds in 2008; there is still plenty of activity in the mid-market, and distressed assets may present some good-value acquisition opportunities.

To open the discussion, the following best-practice points were drawn out as a guide for leaders and stakeholders making their way through the 'belly' the 'beast' that is private equity.

- People are the priority: a deal will only succeed when there is top talent on board.
- After people, look at the product and then at the projections – this is the 'PPP' rule.
- Have a realistic and deliverable plan. Companies that hit their first year's targets tend to stay successful.
- Never compromise on due diligence and vet all potential sponsors well.

- Choosing the right partner is key to success: some private equity houses specialise in certain sectors, while others are experienced in deals of a certain size.

- Employ a good advisor: management teams are usually inexperienced in buy-outs and need to take extra care.

- It is never too early to consider a management buy-out: only act, however, when there is a clear vision for a new direction for the company.

- Set up a clear framework to ensure ethical and proper conduct during the buy-out process, particularly if the transaction is taking a public to company into private ownership.

- Act honourably when dealing with departing employees, whether they leave on good or bad terms, and try to reward people with equity as widely as is possible.

- Clearly align the management team's interests to those of the company: the management is the key to driving value, and their remuneration deal should be regularly reviewed to keep them focused.

- If management can foresee trouble for the new company, be sure to communicate early with the sponsor and other stakeholders and do not be afraid to present a new, more viable plan that will assist with renegotiation of banking/bank covenants and other commitments.

The Belly of the Beast

Private equity funds are limited partnerships between a private equity house and its investors. The firm invests in companies in its portfolio, and is answerable to its investors, who receive an industry-standard 80 per cent of profits. The fund charges a management fee, to cover overheads, and its managers take 20 per cent of the capital value increase ('carried interest') as an incentive to perform well. They must also have a 'skin in the game' – personal money invested in the fund. The fund's capital is then leveraged, to increase its buying power, and the bank debt is placed in the portfolio companies, not in the fund itself.

Typical fund structure

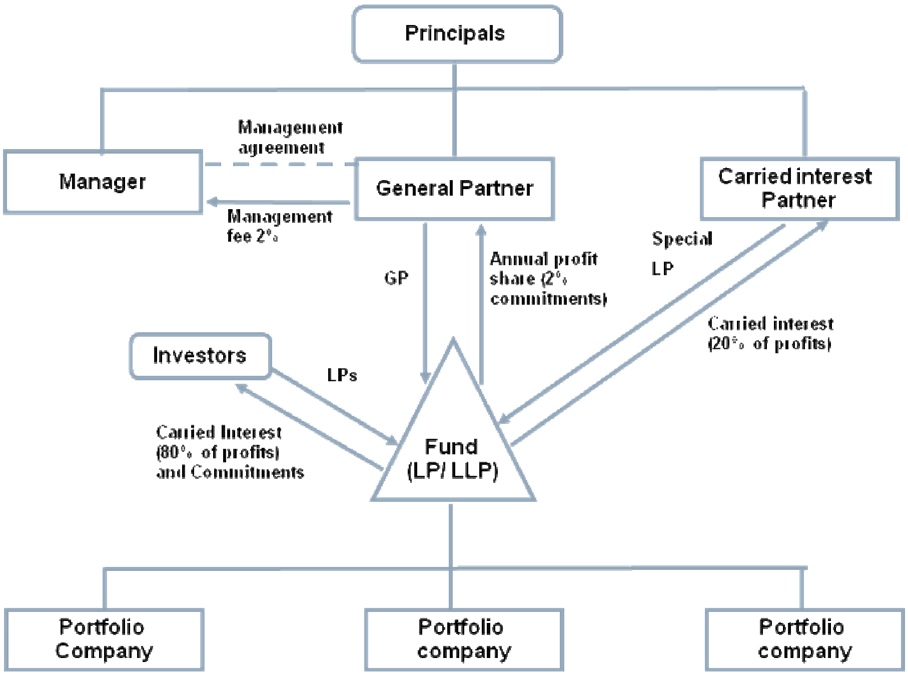

Figure 1: Typical fund structure

However complex investment structures become, there are basic truths to successful deals:

- Follow the PPP rule: look at the people, product and projections in that order. Talented people are the crucial ingredient. If someone is not up to the job they must be replaced: this is a leader's duty both as a manager and an investor. To have the greatest chance of success, a manager mounting a buy-out must surround himself with the best team he can pull together. Effective non-executive directors (NEDs) and a strong chairman can make the difference between success and failure.

- A company's plan must be realistic and deliverable, and absolutely adhered to. The statistics suggest that the majority of businesses that hit their first year's targets stay successful, while those that don't are forever playing catch-up. During the preparatory stages of an MBO it is common to use many sets of projections, depending on the context and the audience; once running the business, however, there must only be one set of numbers.

- Never compromise or cut corners during the diligence process. This includes asking awkward questions of the private equity house. A management team will probably only ever conduct one buy-out, whereas this is the fund's bread and butter. While it is not in the sponsor's long-term interests to make a bad deal with a management team, it nevertheless pays to be as careful as possible. Bring an experienced advisor to the negotiating table and talk to managers and board members in the private equity house's other portfolio companies, to get a true idea of their behaviour.

Finally, consider the exit strategy. If there is no exit route, then walk away from the deal. Private equity formerly sought a three-to-five year sale but now that the future is less certain, firms must have a more flexible outlook.

Which companies are suitable for a management buy-out?

For a buy-out to be successful, the management must understand the business intimately, and be sure that their plans for it are more profitable than the incumbent regime's business strategy. Or alternatively that they can drive the existing strategy harder and faster to deliver incremental shareholder value quicker.

The second crucial factor for a successful MBO is price: is the asset available for a reasonable sum? Management teams considering a buy-out should set in stone the maximum price they will pay and walk away if it is surpassed. The delegates thought that a lack of such discipline in the last few years contributed to the financial bubble that recently burst.

Selecting a partner

Selecting the right fund to partner an MBO is crucial. This is partly about knowing what you, as a management team, want to achieve. Other factors to take into account include:

- The size of the investment: make sure it is right for the partner.

- Sector expertise: some funds have a long history of working with certain industries.

- Club deals: in larger deals a number of private equity firms may club together to acquire the asset. Management should seek to understand the Investment Agreement and ensure that the business, and future key business decisions, will not be compromised by it. In such deals management can expect to spend significant amounts of time managing the often conflicting interests of members of the 'club'. In the current environment, where many deals require a greater equity component, more deals may be done this way.

- The type of transaction: for example, taking a public company into private hands, possibly as part of an auction process, is surely the most complex kind of buy-out, and not all firms are up to the challenge.

- The investors' return requirements: the cost of debt, mezzanine debt and equity have all risen, and different investors will have different strategies and expectations.

- Control: how much will the sponsor want and are you willing to concede?

- Chemistry: a deal will not work out if the management team cannot work with their sponsor.

Making the MBO move

When is the right time to make the MBO move? It is never too early to consider the options, although the delegates cautioned that some companies automatically fire any managers caught planning a buy-out bid.

Clearly, there are legal issues for management and board members, who have a duty not to breach service agreements and confidentiality arrangements. Nevertheless, it is common that executives, lawyers and fund managers talk as friends on an informal basis – on the golf course, for example. This can help establish whether the circumstances are right and a buy-out is viable.

In all deals, there is a gestation period lasting many months, time in which the private equity house can complete all research through public material, so it is ready to look at confidential documents when the buy-out gets going.

Several participants who had been through management buy-outs commented on the difficulty of separating their roles as company executive and potential purchaser. For example, it may be an executive's duty to serve their shareholders and sell to the best bid, regardless of personal ambitions after the buy-out. It is also difficult, they said, to enter a potentially adversarial relationship with the NEDs, who are obliged to try to drive the price up and protect shareholder value. It is important to have rigorous mechanisms and confidentiality agreements in place, a line in the sand so that managers can be sure when they are 'offside'.

However, the group attested to the ethics and professionalism within the private equity industry – despite public perceptions to the contrary – and the integrity shown by management teams undertaking successful buy-outs.

Employing an experienced advisor mitigates these potential risks. Success boils down, once again, to the quality and integrity of the people involved, the clarity of their thought and of the advice they are given.

Management incentives

Management teams involved in a buy-out can expect to receive a salary and a cash bonus for their work, albeit a smaller bonus than they might get in a plc. They might also receive shares of two types including, 'sweet equity' and 'institutional equity'; sweet equity is given on favourable terms, as a reward for their work. It will generally 'vest' with management over the first three years, but usually has to be relinquished if they leave the company. Institutional equity is given for real cash investment and can be retained when leaving.

In recent years, so-called 'ratchets' have become widely used. This is where the management initially takes, say, a 10 per cent equity stake in the business, which increases if performance targets are hit. However, some participants in the discussion disapproved of ratchets, believing that they show indecision, or a failure to negotiate upfront contracts properly.

It is crucial to keep managers' interests aligned to those of their company. For this reason, the group recommended both sides regularly review remuneration deals in the light of developments in the company and the wider economy. Many private equity firms are resetting their managers' deals with some introducing cash bonuses against the achievement of specific improvement targets, for example, if management achieve debt reduction targets. Cash bonuses are attractive in the current environment, (notwithstanding the new 50 per cent rate of income tax) where management may have concerns as to the likely value of their sweet equity on exit.

One participant also counselled that buy-out leaders look after the second tier of managers in the portfolio company. This is likely to contain the future high fliers – an important consideration if a company is to become a medium-term investment.

Although in ideal circumstances a sale will happen in three-to-five years, these are difficult times. The management team must always be ready to 'go again', advised the group. Having a viable Plan B will help the business prosper and will provide comfort to the private equity firm that value will be realised, albeit later than originally planned. In return the private equity firms must be willing to restructure the sweet equity incentive packages so that management stay engaged and focused on delivering Plan B.

Good and bad leavers

It is inevitable that there will be staff turnover during a management buy-out, as not everyone will be suitable or desirable for the new regime. Much attention is paid to 'good leaver' and 'bad leaver' clauses because of this; in reality, however, the operation of these clauses will rarely be black and white.

The group called for a degree of common sense and compassion in dealing with people. If someone has given sterling service to the company yet is no longer required, then these good years must be recognised. Reputations are now too valuable to both individuals and private equity firms for it to be any other way. Try to spread equity as widely as possible, said one delegate, so that as many people's contributions as possible are recognised this way. Another delegate counselled that the equity must not be spread too thinly.

THE NETWORK
OF LEADERS
CRITICALEYE

Over-leveraging in the downturn and other worries

It makes a big difference to the buy-out's chances of success, and to morale, if the management team feel they 'own' the banking documents, and are in control. To do this, they should look months, not weeks, into the future to anticipate problems, but at the same time keeping a clear focus on cash and short-term cash forecasts. Several delegates commented that being under private equity ownership brought a whole new focus on cash: cash preservation and cash reporting.

However, the current financial climate has caught many people out: they find themselves in danger of breaching their covenants, with little possibility of re-engineering their agreements. If this is the case, it is best dealt with head on: the chief executive or finance director should talk to their private equity house, explain the situation, and present a viable alternative plan.

In addition, management teams often worry about the warranties they are required to give either at the time of the initial buy-out, or on the eventual exit. Warranties are generally not intended to be punitive, but rather, to ensure that management have not covered up any significant downsides and to provide confidence to the sponsors. As such, they can be discussed and negotiated. A reasonable warranty exposure on entry stands at about three times a manager's salary, but a manager should employ a good lawyer or advisor, and keep track of the information they have disclosed throughout the negotiation process. On exit the same principles apply but management are better placed to reduce their exposure under warranties. Thought should be given to obtaining Warranty and Indemnity insurance.

Owing to some high-profile defaults, some private equity houses are blacklisted by the main banks at the moment. For this reason, a management team should fully investigate potential sponsors and choose their investors carefully.

Criticaleye (http://www.criticaleye.net), as a community of senior executives, provides members with an experiential platform that allows them to innovate and develop by sharing business experiences and expertise with their peers from different industries/functions. For more information on Executive Membership please contact Tom Beedham on +44 (0)20 7350 5104 or tb@criticaleye.net