Private Equity Exit Strategies

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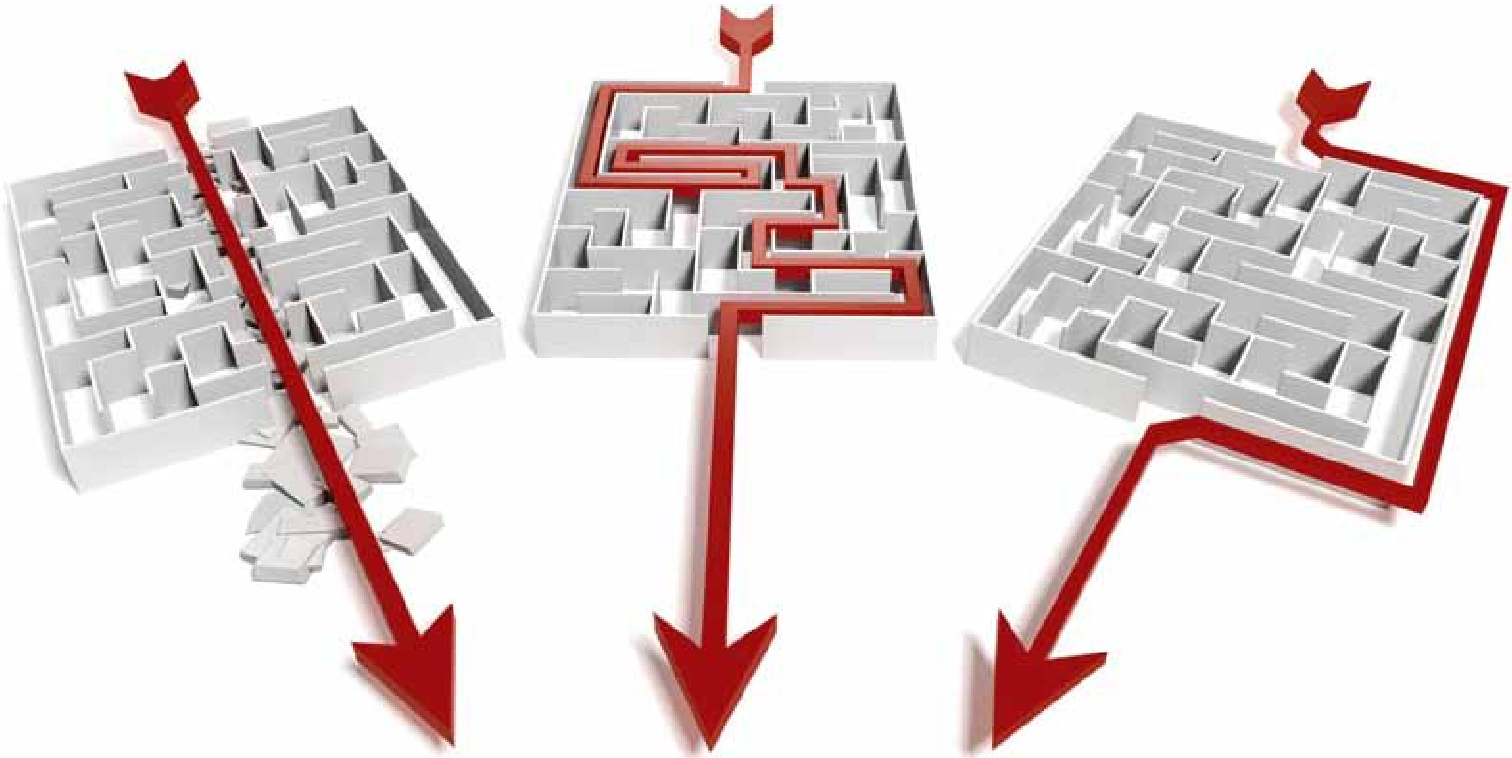

After almost two years of limited exits, it seems that private equity funds are now gearing up to off load many of the investments that were being retained in this period. However, exiting is still not an easy proposition. In this article, **Tim Farazmand** *of LDC, supported by the views and comments of others, explains the typical exit strategies and what can be done to make them work.*

Two years of limited private equity exits have seemingly come to an end with the second quarter of 2010 seeing the highest number since the first quarter of 2008. Research by Ernst & Young suggests that global exits are trending upwards with nearly twice as many exits over the first quarter of 2010 than the same period of 2009.

"With the tightening of lending criteria by the banks in the aftermath of the 'credit crunch', M&A activity will be driven more by business fundamentals and less by the value enhancing features of financial engineering. There will always be bargain hunters looking for businesses in financial distress but well run companies with a clear strategy and visible future earning streams will be increasingly in demand and able to attract a premium rating, regardless of whether the exit route is via a market listing, trade sale or to private equity investors," says David Frankish, Chief Executive Officer at NFT Distribution.

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The general economic mood and volatility in the global equity markets has stifled many exits, leaving no doubt that many firms are eagerly awaiting the appropriate time to exit investments. "The numbers will tell you that there is a backlog of deals that have to happen, as the various funds that own them approach their end date," says Neil Tregarthen, Chief Executive Officer, NES Engineering.

There are three traditional exit routes for private equity investors – trade sales, secondary buy-outs and initial public offerings (IPOs). Stephen Perkins, former CFO of Hawksmere, advises "it is important to remember that, in order to maximise value, you should let the business/business model determine the most appropriate form of exit. For example, there are some businesses (those with significant scale have strong visibility of future earnings with a well-respected management team) that will be perfect for IPO or secondary buy-outs. Whereas there are others that may have a more lumpy earnings profile but will excite trade buyers due to ease of integration, level of synergies available or strategic importance."

As a precursor to any of these three exit routes, private equity investors can look to a refinancing or recapitalisation to obtain a partial exit. Re-gearing the balance sheet can allow capital to be returned to all investors as well as potentially facilitating a restructuring of shareholdings.

As uncertainty in the global equity markets continues to make pricing a challenge, trade sales and secondary buy-outs have proved to be more popular among firms than IPOs as an exit mechanism.

TRADE SALES

According to Robin Johnson, Partner at Eversheds, trade sales are still far more likely to go through than other types of purchases, as they offer more certainty. Often referred to as the only 'true' exit route, a trade sale is usually the preferred long-term exit route for private equity, as it allows all management and institutional investors to be entirely cashed out. A private equity investor needs to identify potential trade acquirers early on and work out a plan to engage with this buyer pool on a timely basis. This enables the investor to understand the trade buyer's acquisition criteria and help it position its investee company accordingly.

Stephen says, "With debt leverage harder to come by, trade buyers have become more active and are looking to source value enhancing acquisitions. They will pay a fair price when they find them and will usually satisfy the price in cash."

SECONDARY BUY-OUTS

Second, and sometimes third, round private equity buy-outs accounted for 35 per cent of the $101 billion of buy-outs completed worldwide up to August 2010. In fact, over the last 10-15 years, it has become increasingly common for private equity investee companies to exit via secondary buy-outs. Typically, this is done on a company-by-company basis although there are a number of examples of 'pools' of investee companies being acquired from a single private equity investor.

There is an expectation that the secondary buy-out market could be particularly positive in 2010/11 as there is a 'wall of money' that must be invested by private equity funds or it will have to be returned to the fund investors.

As with any exit, there needs to be something in it for the next owner. To that end, an investor must position the investee company so that it can show robust and continued shareholder value growth. There is a risk though that this market could have a negative feel to it, especially if companies move from one private equity investor to another on multiple occasions. If a business has been 'owned by the trade' for many years, is it really creating strategic shareholder value?

Finally, this form of exit, whilst potentially providing a complete exit for the institutional investor, will often require management to reinvest a substantial part of their gain.

INITIAL PUBLIC OFFERINGS

I have always espoused a very simplistic view of an IPO as an exit route. If it delivers access to cheaper capital of quoted paper to help finance a consolidation strategy or accelerated organic growth then it should be considered. Otherwise, it is best avoided.

An exit via IPO is entirely dependent on market liquidity and, as has already been seen in 2010, if the quoted market is 'shut',

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an IPO cannot be undertaken - no matter how well positioned the investee company is.

At the top of the market, it was possible for an IPO to facilitate a complete exit for an institutional investor but never for management. In the current market, it is highly unlikely that both can exit entirely via an IPO.

CREATIVITY

The build up of private equity investment I mentioned earlier suggests that firms may be looking at more creative ways of exiting than dictated by tradition. Neil illustrates: "In the halcyon days of private equity, you didn't have to be too creative because trade buyers, tertiary PE buyers and stock market flotations were all happening at good multiples. The world post Lehman Brothers and the banking crisis is, however, a totally different place and now there is undoubtedly the necessity for creativity. The trouble is that firms are starting from zero in regard to a more creative approach, making it difficult to change previous dominant logic about how to exit investments.

"Perhaps we'll see partial exits with houses rolling over some of their investment via seller loan notes, or retaining a stake in a flotation situation and agreeing to sell it when there is an orderly market for the newly quoted shares in the future. Of late, we've even seen some houses doing all equity deals when buying from each other, thus putting a lot of their cash to work - albeit not at the likely stellar returns they generated in the good old days!"

MANAGEMENT

Throughout the period of private equity ownership, management teams should have one eye on exits. By its nature, PE investment is short-term. Therefore, it is important to drive management to take on the agenda of the fund.

To help prepare for an exit, management teams should:

- Eliminate value detractors, eg, unqualified pension liability
- Remove areas of uncertainty
- Drive value-adding activity, eg, organic expansion, new products
- Transfer fixed costs to variable costs in order to facilitate synergy benefits for an eventual acquirer

LOGISTICS

The Chairman of Criticaleye, David Cheyne, comments that, "On exit there is an interesting dynamic about who is responsible for the deal. The private equity manager believes it is their job, however they do not know the business as thoroughly as management. Common practice is to keep management focused on their day jobs, but there is increasing evidence that having a senior member of the management team assisting the exit team leads to a smoother transaction and greater value for shareholders."

Stephen says, "Successful exits (in my experience) come about when two things align: 1) Strategy – ie, it is the right time in the businesses evolution/business plan and 2) Management and investors all agree that a liquidity event should occur. If one (or both) of these factors are not in place, then pushing through an exit will be hard work."

However, it is important for private equity backed companies to remember that an exit may not always come when it is best for the company. Funds will often exit organisations for their own reasons - perhaps as a result of pressure from their own shareholders or owing to legislation. This is why it is vital to know and understand the funds, as well as the environment in which they are operating.

The key points are that a private equity investor needs to do a material amount of work on the future exit strategy ahead of investing. If you don't know how you're ultimately going to exit, then don't invest!

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